TAMING FINANCIERS: THE POLITICAL ECONOMY OF EXCHANGE RATE POLICY IN EASTERN EUROPE

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Throughout the transition and developing world, the choice of exchange rate regime is one of the most important and controversial policy decisions. What are the main factors that determine the choices of governments in exchange rate policy? What are the structures and institutions that allow governments to credibly commit to and sustain a fixed exchange rate regime? These are the central questions for this study. To answer these questions, I examine the puzzling variation in exchange rate regime choices in Eastern Europe (EE) and changes in these choices over time. This study is an attempt to explore the determinants of the "de facto" exchange rate arrangements chosen by policymakers in EE. I combine the choice and the sustainability of fixed exchange rate regimes in a political-economic approach.

The project's central finding is that exchange rate regime choices depend on several factors: first, on the different interests and strategies of incumbent domestic (state-owned and private) and foreign banks in determining exchange rate policies; and second, on the bank ownership structure and institutional variation of national financial systems. The variation in national financial systems between EE countries is, in turn, a function of the variation in privatization strategies and openness to foreign investments in the banking sector. This research thus demonstrates how the connection between financial interests and exchange rate regime choices is mediated by domestic financial systems. This dissertation integrates theories of financial development into interest groups theories in the political economy of exchange rates.

I evaluate this argument against two types of evidence. Statistical analysis of cross-national time-series data allows me to test the impact of financiers on exchange rate policies against a sample of twenty-five EE countries between 1990 and 2004. Statistical analysis is accompanied by in-depth examination of four theoretically important cases—Bulgaria, the Czech Republic, Poland, and Estonia—based on a thorough reading of the relevant secondary literature, the perusal of central bank, government and archival documents, and the conducting of 105 semi-structured interviews. The thesis develops a novel four-fold typology of financial systems in EE—capture, collusion, consensus, and competition—exemplified by the four countries.

BIOGRAPHICAL SKETCH

Jana Grittersova is an Assistant Professor at the Department of Political Science at the University of Riverside. Her research agenda focuses on the political economy of international finance, exchange rates and financial crises, central banking, institutions and development, globalization, European integration, and transition economies. She obtained her Ph.D. in Economics from the University of Economics in Bratislava, Slovakia, and her Master in Arts in International Relations from the University of Kent at Canterbury, United Kingdom. She has previously taught at the University of California, Berkeley and Stanford University.

Furthermore, her professional experience also includes work for the European Commission in Brussels and the National Bank of Slovakia. She is the recipient of the British Chevening Award, a pre-doctoral fellowship from the University Ca'Foscari in Venice, Italy, and a fellowship from the Institute International d'Administration Publique in Paris, France. She was a visiting research fellow at the central banks of Bulgaria, the Czech Republic, and Poland. She has received additional training at the European School on New Institutional Economics and attended the summer MBA program at the Vienna University of Business Administration and Economics in Austria. Besides English and her native Slovak, she is fluent in French, Italian, and Czech and has a working knowledge of Russian and German. Her monograph, "The Redefinition of the Transatlantic Partnership," was published by the Slovak Foreign Policy Association, and her other publications on independence of central banks, European monetary integration, European Union enlargement, and short pieces on U.S. foreign policy have appeared in peer-reviewed journals and policy magazines. Her economic analyses and legal decisions on the European competition law are published in the *Official Journal of the European Communities*.

For my family

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On a more personal note, I am indebted to my mother and to my brothers and sisters for their warm support during the long journey of graduate school. My father would have been proud to see my accomplishments. Finally, my greatest debt is to my husband, Jérôme, who lived throughout the highs and lows of this project with love, patience, and enthusiasm; and to my newborn son Adrian for the life that makes it all worthwhile.

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Bank Gdanski (BG)
Bank Gospodarki Zywnosciowej S.A. (BGZ),
Bank Handlowy w Warsawie S.A. (BH)
Bank of Estonia (Eesti Pank, BOE)
Bank of Lithuania (BOL)
Bank Przemyslowo-Handlowy (BPH)
Bank Slaski (BSK)
Bank Zachodni (BZ)
Bulgarian National Bank (Blgarska Narodna Banka, BNB)
Bulgarian Socialist Party (BSP)
Central and Eastern Europe and the Baltic States (CEB)
Central Bank of the Republic of Armenia (CBRA)
Central Bank Independence (CBI)
Civic Democratic Party (ODS)
Commercial Bank (Komerční Banka, KB)
Commonwealth of Independent Countries (CIS)
Council for Mutual Economic Assistance (CMEA)
Currency Board (CB)
Czech National Bank (Česká národní banka, CNB)
Czech Savings Bank (Česká Spořitelna, CS)
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Eastern Europe (EE)
European Bank for Reconstruction and Development (EBRD)
European Monetary Union (EMU)
European Union (EU)
Democratic Left Alliance (SLD)
Direct Inflation Targeting (DIT)
General Credit Bank (Všeobecná a Úverová Banka,VUB)
Generalized Estimating Equation (GEE)
Generalized Least Squares (GLS)
Generalized Method of Moments (GMM)
Gross Domestic Product (GDP)
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Initial Public Offerings (IPOs)
International Monetary Fund (IMF)
Investment and Postal Bank (Investiční a Poštovní Banka, IPB)
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Maximum Likelihood Estimator (MLE)
Monetary Policy Council (Rada Polityki Pieniężnej, RPP)
National Bank of Azerbaijan (NBA)

National Bank of Georgia (NBG)
National Bank of Hungary (NBH)
National Bank of Poland (Bank Narodowy Polski, NBP)
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North Estonian Share Bank (NESB)
Optimum Currency Areas (OCA)
Organization for Economic Cooperation and Development (OECD)
Polish Peasant Party (PSL)
Pomorski Bank Kredytowy (PBKS)
Powszechna Kasa Osczednosci-Bank Panstwowy (PKO BP)
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Powszechny Bank Kredytowy (PBK)
Reinhart and Rogoff (R&R)
Southeastern Europe (SEE)
Sovereign Wealth Funds (SWFs)
State-Owned Banks (SOBs)
Special Drawing Rights (SDR)
State Bank of Czechoslovakia (SBCS)
State Savings Bank (Durzhavna Spestovna Kasa, DSK)
Swedbank and Skandinaviska Enskilda Banken (S-E Banken)
Tartu Commercial Bank (Tartu Kommertspank, TCB)
Turkish Movement for Rights and Freedoms (MRF)
Union Baltic Bank (Balti Uhispank, UBB)
Union Bank of Estonia (UBE)
Union of Democratic Forces (UDF)
United Democratic Front (UDF)
Wielkopolski Bank Kredytowy (WBK)
Živnostenská Banka (ZB)

CHAPTER 1

INTERESTS, INSTITUTIONS, AND EXCHANGE RATES

Closing off all avenues for discretionary monetary policy
not just for a time but for the foreseeable future
is something that few societies are prepared to do.

Barry Eichengreen[1]

This dissertation is a study of how governments make their decisions regarding exchange rate policy. Exchange rate stories have always been at the center of international economic relations and have dominated economic headlines throughout history. Witness the recent intense U.S. criticism of the Chinese "hard" yuan policy in the face of this emerging economic giant or the panic about the U.S. dollar's loss in preeminence in the global monetary system as investors switch to the euro as an alternative. Exchange rates have also been endowed with symbolic importance and prestige. In Kindleberger's words, "A country's exchange rate is more than a number. It is an emblem of its importance to the world, a sort of international status symbol" (1970: 198).[2]

The choice of exchange rate regime is one of the most important macroeconomic policy decisions that are made in transition and developing countries. This choice can strongly influence their freedom of action, the effectiveness of their economic policies, the stability of their financial systems, and the growth of their economies. As a result, *benign* neglect of exchange rates is not a feasible option for these countries (Domac and Martinez Peria 2000). Misguided choices of exchange rate regimes have led to financial crises in many countries, often with severe domestic and international consequences. For example, the Russian financial crisis in 1998 triggered

[1] Eichengreen (1999: 105).

[2] Also quoted in Kirshner (2003: 15).

a panic on international financial markets. The ruble lost over eighty percent of its value, and the government defaulted on its foreign debt. The worsening economic situation has also created a political crisis in Russia: President Yeltsin dismissed Prime Minister Sergei Kiriyenko, who had been appointed to the post just six months earlier. The financial meltdown in Russia, the collapse of the peso in Mexico in 1994, the Asian financial crisis in 1997–1998, and the 2001–2002 Argentine crisis, to name just a few financial crises in emerging markets in the 1990s, put the debate over the appropriate exchange rate regime at center stage once again.

What are the main factors that determine the choices that governments make with regard to exchange rate regimes? What are the structures and institutions that allow governments to commit credibly to and sustain a policy of anti-inflationary fixed regimes? I argue that the governments in countries with financial systems dominated by state-owned banks (SOBs), accompanied by weak monetary and regulatory institutions, are less willing and able to commit to and sustain fixed exchange rate arrangements than when systems of finance are characterized by greater participation of foreign banks in financial intermediation. If we explain an exchange rate policy as resulting from diverse financial institutional structures, the next question is: What are the sources of this diversity of financial development across nations? These are the two central questions for this study. To answer these questions, I attempt to explain the puzzling empirical variation of exchange rate regime choices in the transition states of Eastern Europe (EE) and the changes in these choices over time.[3] In

[3] EE countries examined in this study are divided into three groups according to the classification of the European Bank for Reconstruction and Development (EBRD): 1) Central and Eastern Europe and the Baltic States (CEB): Czech Republic, Hungary, Poland, Slovak Republic, Slovenia, Estonia, Latvia, and Lithuania; 2) South-Eastern Europe (SEE): Bulgaria, Croatia, Romania, Albania, FYR-Macedonia; and 3) the Commonwealth of Independent Countries (CIS): Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. Bosnia and Herzegovina and Serbia-Montenegro are excluded from my analysis because of insufficient data.

spite of broad similarities in circumstances, EE countries adopted rather diverse exchange rate regimes during the post-communist period. I also explore the sources of the diversity of financial development in the post-communist EE. I argue that the variation in national financial systems among EE countries is a function of the variation in privatization strategies and openness to foreign investments in the banking sector.

There can be little doubt that financial interests and institutions increasingly influence macroeconomic policy in both developed and developing countries. Yet, the existing theoretical and empirical literature says little about the role of financial linkages and national financial development in the choice of exchange rate regime. This is a serious deficiency because the consequences of international financial integration and the effects of banking problems on the balance-of-payment crises in the 1990s and in the 2008 global financial crisis demonstrated the importance of financial institutions in exchange rate policies and financial crises.

As this study becomes finalized, the United States and much of the world are grappling with financial and economic crises. The global financial crisis of 2008 has provided a reminder that a financial crisis is a political phenomenon. The deeper cause of this crisis is the power politics of financial institutions. The U.S. "shadow banks" that defined deregulated American finance made the financial crisis possible by helping to create the biggest credit and housing bubble in history. Financiers in the United States and in other parts of the global financial system captured their regulators and took on excessive risks (Johnson 2009). In particular, in developed countries, such as the United States and the United Kingdom, the financial sector has accounted for an unsustainable share of corporate profits and profit growth.[4] The U.S. government

[4] In 1986, Wall Street's profits made up just 19 percent of total corporate profits but 40 percent of American corporate profits in 2006 went to the financial sector (Summers 2008).

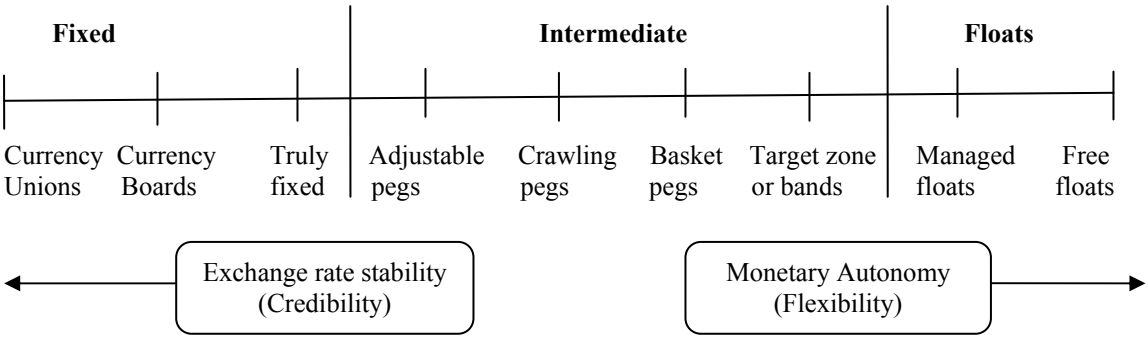
reacted to the financial storm by making its most dramatic interventions in financial markets since the Great Depression. The turmoil has also spread across the globe. The dramatic collapse of Iceland's economy, endangering savings from depositors in Britain and elsewhere, has highlighted risky corners of the world's financial system. Five European banks failed and European governments propped up their banking systems with rescues and guarantees. Because of their reliance on funding from Western banks, EE economies have been severely affected by the financial crisis, as well. Rising unemployment and depreciating currencies are fueling popular discontent. The Hungarian and Latvian governments have already fallen as a direct result of the financial crisis. In January 2009, violent protests erupted in Latvia, Lithuania, and Bulgaria over their governments' handling of the economic crisis.

My research departs from the optimum currency area theories–the dominant approach to exchange rates–which focus on various macroeconomic fundamentals, as well as from the existing literature on the political economy of exchange rates by exploring how different groups of banks affect cooperation in both monetary and financial relations among EE states. I offer novel, testable hypotheses regarding banks, differentiated by the nature of their ownership, whose impact on exchange rate policies is not theorized in the existing literature. I also suggest that the comparison of financial systems in general and the role of banks in those systems in particular cannot be fully understood without due regard to the political and institutional environment in which these economic actors operate.

This study combines the choice and the sustainability of fixed exchange rate regimes in a political-economic approach. The decision to adopt a fixed regime limits a government's room to maneuver because economic policies must be consistent with such a regime. I examine the determinants of *actual* exchange rate arrangements chosen by policy makers in the transition economies of EE.

Exchange Rate Regime

I begin by conceptualizing the phenomenon of interest: exchange rate policy of national governments. The national exchange rate policy involves the choice regarding the exchange rate regime as well as the choice regarding the preferred level of national currency. The focus of this study is on exchange rate *regime*, which concerns choice of the degree to which the national currency is allowed to fluctuate against its anchor currency, e.g., the US dollar or the euro.[5]



Source: Frankel (1999), Hall (2005)

Figure 1.1: The spectrum of exchange rate regimes

As figure 1.1 shows, there are several alternative exchange rate regimes prevalent today that can be arranged along the spectrum by the degree of fixity from a full float to a currency union (Frankel 1999, Edwards and Savastano 1999, Bordo

[5] The national exchange rate policy also involves the choice regarding the *level* of the currency value: governments define their preferences for "strong" (relatively appreciated) or "weak" (relatively depreciated) currency. Real appreciation of a domestic currency means greater purchasing power for domestic consumers. But appreciated currency also means increased foreign competition for domestic producers of tradable products because it makes their products more expensive vis-à-vis foreign goods. Real depreciation has the opposite effects: a weaker currency encourages exports of local tradable products, leads to improving competitiveness for domestic producers, and helps to reduce trade and payment deficits. A depreciated currency, however, raises the prices of foreign goods and services to domestic consumers and thus decreases national purchasing power. The choice of the level of currency involves the trade-off between purchasing power *(*achieved through a fixed nominal and/or appreciating real exchange rate) and competitiveness (achieved through a depreciated real exchange rate) (Broz and Frieden 2001, Bernhard, Broz, and Clark 2003).

2004).[6] At the fixed-rate end of the spectrum is the option of currency union, in which the members share common currency, like the euro-zone. The next choice is a currency board (CB), in which a country has a separate currency but only when fully backed by inflows of foreign exchange, and there is no role for discretionary monetary policy or a lender of last resort.[7] In a currency board arrangement, on the other hand, a government retains the political symbolism of its own currency and can still earn interest on its foreign exchange reserves (Hall 2005: 5).

Intermediate regimes run from adjustable pegs under which the nominal exchange rate is fixed but governments can periodically adjust the parity; to crawling pegs in which the peg is regularly reset in a series of devaluations; to basket pegs where the exchange rate is fixed in terms of a weighted basket of foreign currencies; to target zones or bands where the nominal exchange rate is allowed to fluctuate within a band, while the center of the band is a fixed rate.

Flexible regimes are divided into two groups. Free floats mean that the monetary authorities do not intervene, allowing the value of foreign exchange rate to be determined in the market. In managed floats, the central bank sporadically intervenes in foreign exchange markets, and adjusts money supply through raising or lowering interest rates.[8] Free floats and irrevocably fixed regimes, that is, monetary unions or currency boards, represent opposite ends of the exchange rate spectrum. They are referred to as the "corner solutions" to the problem of exchange rate regime

[6] For various classifications of exchange rate regimes, see chapter 4.

[7] Under a *strict* currency board, there is no actual domestic monetary policy because both the monetary base and the level of interest rates are *endogenously* determined. The currency board does not have the right to issue central bank money against any domestic assets. Under a *modified* currency board, a limited number of monetary policy actions are performed, such as lender-of-last resort or limited open-market operations (Hallenberg and de Souza 2000: 9).

[8] In addition to active interventions in foreign exchange market resulting in changes in international reserves central banks use also indirect interventions through changes in interest rates or liquidity that do not influence reserves (Edwards and Savastano 1999).

choice. The research here investigates why states choose and sustain fixed instead of flexible regimes, so I will focus predominantly on these two categories of regimes.[9]

As figure 1.1 illustrates, government trades off exchange rate credibility (stability) and flexibility (monetary autonomy) across the spectrum of exchange rate regimes (Frankel 1995, Rodrik 1993, Edwards 1996). At one end of the spectrum, irrevocably fixed exchange rates bring a higher degree of credibility to policy-making and the relative stability of the currency over time. In a fixed regime, the central bank declares the value for the exchange rate that it will act to maintain. A currency's value is matched to the value of another currency, to a basket of currencies, or to another measure of value, such as gold. On the other end of the spectrum, government gains monetary autonomy, that is, the ability to use interest rates to achieve domestic economic goals like price stability or employment. Thus, government gains flexibility to accommodate domestic and foreign shocks, including changes in external terms of trade and interest rates.

A Puzzle of the Exchange Rate Regimes in Transition[10]

I use the EE region as a testing ground because it provides a new laboratory to test current theories on exchange rates. Moreover, I have chosen to study exchange rate policies in EE because they have played a crucial role in post-communist economic development. Under the command economy, exchange rate served as a unit of account for statistical purposes, but it had a very limited impact on actual trade flows (Radzyner and Riesinger 1996: 20). At the beginning of the 1990s in EE, market institutions like central banks, financial systems, bankruptcy laws, and property rights

[9] This study does not examine the determinants of realignments within fixed exchange rate, that is, devaluation or revaluation of the parity within a fixed regime or changes in the width of fluctuation band. It only focuses on transitions between fixed and flexible regimes.

[10] For a fuller discussion of the evolution of exchange rates in EE states, see chapters 4, 5, and country studies (chapters 6-8).

were virtually non-existent, and market mechanisms were weak or absent. Therefore, the exchange rate has served as the most important price in EE states. Radical changes in asset prices can disrupt the markets on which the economic welfare of the population depends.

Exchange rate policies have been contested, proving to be controversial issues throughout the transition from a command to a market economy. These policies were devised to achieve price stability and to open up previously closed domestic markets to the global economy. In order to achieve these objectives, EE countries adopted rather diverse exchange rate regimes, ranging from free floats to currency boards, and experienced several regime shifts. These shifts were the result of proactive policy management as well as forced changes related to financial crises. Sharply different regimes continue to coexist, so exchange rate regimes in transition economies exhibit a puzzling degree of heterogeneity both across countries and over time.

Why is this diversity of exchange rate policies in EE puzzling? EE states began the post-communist transformation with similar legacies of communism and large economic imbalances.[11] They faced similar reform program agendas known as the "Washington consensus" and had similar integrationist ambitions with the world economy.[12] Thus, they were expected to adopt similar exchange rate policies (Sachs 1991, Fisher, Sahay and Végh 1996, Schleifer and Vishny 1998, World Bank 1996).

Not only did EE states adopt different regimes at the beginning of transition, but also no uniform trend or particular direction characterizes the evolution of

[11] Transition countries share two principal communist legacies: First, EE states started the post-communist transition with the political legacy of authoritarianism: despite some cross-country variation in the degree of openness of each communist regime, the political and institutional structures were the same in all EE countries (Bunce 1999). Second, they also shared the common legacy of central planning. Command (centrally planned) economies were characterized by the absence of property rights, central planning and administrative control, a semi-monetized financial system, soft budget constraints, and chronic shortages (Kornai 1992).

[12] Three neoliberal stabilization-cum-liberalization reform measures were particularly important: price and trade liberalization; macroeconomic stabilization; and privatization.

exchange rate regimes during the transition period. Transition economies have also used different anchor currencies in different time periods. Some used the U.S. dollar (Albania and many CIS republics), while others pegged their currencies to the Deutsche mark/euro (ex-Yugoslav republics and CEB states). Latvia is an interesting case: its central bank pegged the national currency to the Special Drawing Rights (SDR) before it switched to the euro only in 2004. Neither is progress in political and economic reforms in EE countries correlated with their choices of particular regimes. On the one hand, the frontrunners in transition have opted for different regimes. In 2004, the Czech Republic exhibited a managed float, while Estonia pursued a currency board. On the other hand, transition leaders and laggards adopted similar regimes: compare again the Czech Republic, the leader in transition, with Albania or Moldova, transition laggards; the latter three exhibited flexible regimes. Equally puzzling is why many EE countries practiced exchange rate regimes that were, in fact, different from those they officially proclaimed. Thus, the variation in exchange rate policies over nearly two decades and from country to country in the transition region cannot be easily attributed to systemic factors, common legacies, similar reform tasks, or integrationist ambitions.

In spite of this striking variety of exchange rate regime choices in post-communist EE, existing empirical studies examining the determinants of these choices are few, and they focus mostly on selected EE countries (Corker et al. 2000, Backé 1999, Nehrlich 2002, Bénassy-Quéré and Coueré 2002, Bénassy-Quéré and Lahréche Révil 2000, Hallerberg and de Souza 2000, Domac et al. 2001, Kluyev 2002, Von Hagen and Zhou 2005). These studies only rarely account for the role of political factors (Bodea 2005, Markiewitz 2006).

So a crucial question is: What explains exchange rate regime choices in EE and changes in these choices over time? Why do some countries fix while others float their

exchange rate regimes? This is an important puzzle of the post-cold war world economy. Cooperation and coordination in international monetary affairs depend on national exchange rate policies.

Financiers as the Explanation: A Finance-based Theory

The power of banks is particularly evident in transition in the post-communist region. A "triple coalition" of the "net winners" of the early post-communist reforms, consisting of commercial bankers and investment funds together with state enterprise managers, developed into a strong political force that significantly influenced EE economic policies and systems, often seeking to impede further liberal reforms in order to retain their benefits (Hellman 1998, Johnson 2000). Across EE, banking very early on became one of the few growing sectors, expanding even during the initial recessionary period. [13] This approach explores the influence of banks on the macro-economic policies of the government that acts on their behalf.

Building on the financial development and growth literature and the literature on the effects of financial institutions on balance-of-payment crises, I suggest a new, distinctively *finance*-based approach to the political economy of international finance, in which exchange rate regime choice and sustainability depend on two dimensions: first, the political strength of state-owned, private domestic, and foreign banks with varying interests and strategies in exchange rate, monetary, and regulatory policies; and second, the bank ownership structure and institutional variation of national financial systems. The different financial liberalization and privatization strategies have yielded two principal types of financial systems in the EE region: *clientelistic* and *open.* Financial institutional structures represent a critical intervening variable mediating the connection between financial interests and exchange rate policy.

[13] For example, in Russia, the GDP created in banking, finance, and insurance grew by 57 percent during 1991–1994, while the total GDP decreased by 35 percent (Popov 1999: 15).

The political story of exchange rate policy in this study highlights the interplay of interest groups and institutional structures in policy-making. While my argument shares with interest-based (sectoral) approaches an emphasis on interest groups as a powerful force in shaping government choices regarding exchange rate regimes, I differ in how we assess their significance and implications. Interest-based approaches can answer the question of who benefits and who loses from particular policies. Nonetheless, a serious impediment of existing interest group and lobbying approaches to exchange rates is a missing link between derived preferences of societal groups and policy outcomes. In my framework, bank ownership structure empowers different types of financiers, affects their interests, and influences the responsiveness of governments to their demands. Ownership structure subsequently influences building (monetary and regulatory) institutions of financial governance.

Institutional explanations can identify the political obstacles that governments face. Conversely, the problem with institutionalist explanations is that they neglect the role of societal actors and their influence on policymaking. I argue that if and how governments respond to the lobbying of financiers depends not only on their organization and strength, but primarily on the ownership structure and institutional quality of domestic systems of finance that determine the power, strategies, and the ability of financiers and other societal actors to overturn exchange rate policy or exit.

One important conclusion emerges from this analysis: this study does not present a lobbying argument but rather a structural argument focusing on the impact of institutional structures in finance on economic policies. However, structure and process interact and my interviews and documentary data have given me the information for process tracing of exchange rate policy making in carefully selected case studies, which do involve (interest group) politics in a crucial way.[14]

[14] I am grateful to Peter Katzenstein for this remark.

Chapter 5 and the case studies show how various historical legacies, memories, the national and political purpose of governments, the design of political institutions, and the dynamics of political competition and other factors have, to various extents, impacted the capability of EE governments and reformers to free themselves from old communist party hierarchies and cut their ties to incumbent interest groups, which was consequential for their decisions to stabilize their economies, privatize SOBs, and choose privatization methods, including the choice of letting foreign banks in. Therefore, politics at time t-1 determined the power, preferences, and decisions of political and societal actors for financial reform policies, but what I am really interested in this study is chronicling the downstream consequences of these decisions in exploring the effects of institutional structures of finance on exchange rate regime choice and sustainability at time t+1. This analysis allows a better understanding of the institutional context of finance that frames political decisions and that will ultimately define the political credibility and sustainability of a fixed exchange rate regime policy. It also shows that many banking and financial crises in EE that led to a collapse of currency pegs shared a political component—the tremendous political power of incumbent financiers.

Competing Theoretical Explanations

This study relates and adds new evidence to the research on exchange rate regimes. Economists and political scientists offer a myriad answers to the question of what determines the choices of exchange rate regimes. The optimal exchange rate regime has been a subject of lively debate in international finance, but little consensus has been achieved. A "one size fits all" optimal exchange rate regime does not seem to exist. Rather, the appropriate regime seems to depend on the specific circumstances of the countries and the time period involved (Frankel 1999).

I consider four approaches that focus on (1) optimum area considerations and other approaches of open-economy macroeconomics; (2) the political strength of different interest groups with varying exchange rate preferences; (3) credibility, transparency, and institutions; and (4) various systemic factors. What is clear from recent scholarship is that both economic and political factors influence decisions of policymakers in the exchange rate area.[15] There is, however, no agreement on the relative weight of these factors and the nature of their interactions. These explanations bring fundamental insights on exchange rate policy making. Still, none of these theories is sufficient to explain the exchange rate policies in transition economies. In subsequent sections, I assess the value of competing theories and offer a broad theoretical framework for understanding the role of financial interests and institutions in exchange rate regime choices. Here, I offer only a truncated version of alternative approaches but I will discuss difficulties with applying existing theories of exchange rates in chapter 5 to the post-communist region.

Optimum Currency Area Theories

A large body of literature exists on the economics of exchange rates. The principal set of economic explanations is associated with the theory of Optimum Currency Areas (OCA), according to which the choice of the exchange rate regime depends on the structural characteristics of an economy.[16] The OCA is a geographical area in which member countries should use fixed exchange rates among themselves or, equivalently, have a common currency.[17] The "traditional" OCA theory stipulated the

[15] See Levy-Yeati, Sturzenegger and Reggio (2007) for a recent survey of the literature on exchange rates in economics, and the Autumn 2002 issue of *International Organization* and Kirshner (2003) in political science.

[16] For a survey of OCA literature, see Tavlas (1993).

[17] I should note that OCA theory applies predominantly to adopting a common (perhaps) new currency. The essence of this theory is that the benefits of monetary unification (transparent prices, lower transaction costs, greater certainty for investors, enhanced competition) are balanced against the costs of

criteria to assess fixed rate regimes against flexible ones that include the symmetry of external shocks, the degree of labor mobility, the degree of openness, and the extent of economic diversification (Mundel 1961, McKinnon 1963, Kennen 1969). From the perspective of OCA, by reducing exchange rate risk and transaction costs, a fixed regime is likely to encourage trade and investments, and so spur growth.[18] Thus, small, open economies with a high proportion of economic agents sensitive to exchange rate risk will gain in trade and welfare derived from pegging their currencies to the currency of their large trading partner (Eichengreen and Leblang 2003). Under the high levels of labor mobility in open economies, the exchange rate is less effective as a policy tool.[19] Countries with highly diversified production structures are more likely to adopt fixed regimes than those with more concentrated production (Kenen 1969).

More recently, research considered the development of a country's financial sector in exchange rate regime choice. One should expect countries with underdeveloped financial systems to choose currency pegs because they lack the market instruments to conduct domestic open market operations, and they want to protect their banks against exchange rate instability (McKinnon 1991).

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sacrificing monetary and fiscal autonomy. The OCA theory is the principal theoretical framework for analyzing European monetary integration that examines the question of whether the European Union (EU) constitutes an optimal currency area (Eichengreen and Bayoumi 1996). Nevertheless, for most analysis of OCA, the distinction between a fixed exchange rate and a common currency is not important (except for minor issues of transaction costs and *seignorage*) (Canzoneri and Rogers 1990). This distinction does become important when we consider the credibility of a commitment not to increase the money supply or not to devalue it (Frankel 1995: 42).

[18] Although there is no direct implication from standard OCA theory that the choice of exchange rate regime would have a significant impact on trade and investment, there is a widespread belief that exchange rate stability would promote trade, particularly in open economies. Rose (2000) finds that irrevocably fixed exchange rates triple foreign trade.

[19] If there is a lack of wage or price flexibility in a country with a currency peg, the government may be forced to impose unpopular policies of wage freezes and fiscal tightening in order to sustain economic competiveness.

OCA theory, therefore, specifies conditions under which it is optimal for a country to surrender its exchange rate autonomy. The costs of abandoning monetary autonomy are linked to the asymmetry of economic shocks with potential anchor countries and to the strength of the remaining instruments to deal with these shocks after giving up monetary discretion, e.g., fiscal redistribution. When the shocks affecting a country and its neighbors are highly correlated, there is less need for monetary independence (Frankel 1995).[20]

Nonetheless, OCA structural explanations are insufficient because they cannot fully explain why important differences in exchange rate policy have been observed among economies with similar economic structures. OCA explanations do not appear to be sufficient predictors of exchange rate choices in EE. For example, OCA theory does not explain why CEB states that fulfill most criteria for fixed currency regimes show such divergence in exchange rate policies. These economies are small (with the exception of Poland and Romania and then only in terms of population) and open, similarly endowed with natural resources, located in the same geographic region, with trade heavily concentrated on the Deutsch mark/Euro zone. Furthermore, in spite of relatively constant structural factors, EE countries have changed currency arrangements over time.

More generally, OCA theory identified several economic variables as determinants of exchange rate regimes and a few economic objectives that governments could focus on in conducting their exchange rate policies. These variables include price stability and economic growth. Nevertheless, different economic fundamentals may lead to conflicting pressures for an exchange rate regime.

[20] A recent criticism of OCA theory focuses on the extent to which hard fixes, particularly currency unions, may be endogenously optimal. In other words, the currency union itself brings about area optimality. See Frankel and Rose (1998).

As a result, a regime chosen to achieve one economic objective may undermine the other (Hall 2005: 171).

Empirical research on exchange rates has produced limited support for models based solely on economic fundamentals (Freeman, Hays, and Stix 2000). The results are inconclusive and sometimes contradictory.[21] In general, OCA does not seem to have predictive power (Cohen 1998).

Finally, the arguments based on OCA theory are built purely on efficiency grounds. [22] The costs and benefits of exchange rate regimes are seen from the perspective of a benevolent social planner seeking to maximize social welfare. Nonetheless, in contrast to trade policy, where there are strong economic arguments for the welfare superiority of free trade, there is no clear economic-efficiency argument for an optimal exchange rate regime. OCA explanations are *apolitical*: they ignore that what is optimal for a domestic economy as a whole may not be optimal for particular societal groups. The decisions of political actors about monetary regimes need not be compatible with the general public good.

Societal Groups

In a direct challenge to OCA, societal approaches consider exchange rate policy outcomes as a function of a political competition among "policy demanders"–interest groups, economic sectors, and voters–with different preferences and unequal political and economic power. [23] This literature operates with the

[21] As Richard Cooper (1999: 107) observed, exchange rate studies suffer from the same problems plaguing all empirical work in economics: The results tend to vary with country coverage, time period, and the specifications of the econometric models because "there is no entirely satisfactory way to 'control' for all relevant cross-country differences or for the relevant changes in the domestic and international economic environment over time."

[22] OCA theorists consider distributional effects of currency regimes to be unclear, small, or both (Giovannini 1995).

[23] In addition to these "demand side" approaches, scholars also study "policy suppliers," that is, political institutions including political parties, veto players, electoral systems, legislatures, bureaucracies,

assumption that the choices of exchange rate regimes have distributional consequences.

Frieden (1991) provides the most widely cited "sectoral" (interest group) model of exchange rate regime choice, in which preferences of domestic economic actors are determined by their sectoral interests. His model predicts support for fixed exchange rates from the groups heavily involved in international trade and investments, including international investors, exporters of specialized tradable manufactures, and borrowers because currency volatility may negatively influence their cross-border business activities. These groups will be quite insensitive to the loss of monetary autonomy. In contrast, non-tradable sectors and import-competing producers of standardized products should prefer flexible regimes.[24] Non-tradable producers, whose activities are domestically oriented, are sensitive to the ability of national governments to use currency to improve the competitiveness of their products. Import competing industries can benefit from currency volatility, which may reduce competition from imports by increasing the risks and costs of importing. [25]

Nonetheless, the preferences of tradables, especially exporters, seem to be unclear in Frieden's sectoral accounts. On the one hand, exporters seem to favor fixed

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elections, and so on. See Hallerberg (2002), Clark and Hallerberg (2000), Bernhard and Leblang (2002), Eichengreen and Leblang (2003), Leblang (1999), Clark (2003), Schamis and Way (2003). They build on a principal-agent model, in which the individual citizens (median-voters) function as principals who delegate the formulation of economic policy to agents, usually ideological political parties.

[24] Frieden specifies distributive interests in exchange rate "regime" and "level." While exchange rate levels and regimes are analytically separable, in practice, they are often combined. Maintaining a fixed exchange rate frequently means keeping a strong, appreciated currency. I am grateful to Barry Eichengreen for this remark. Hefeker (1997: 27) further noticed that producers focus on the choice of regime rather than on exchange rate level because the former is more enduring and more manipulable by governments.

[25] Frieden employs the Ricardo-Viner model (endogenous tariff theory in international trade), which predicts that factors of production specific to import-competing (exporting) industries will be protectionist (free trade). The model also assumes that factors of production remain immobile in different industries in the short term. Capital and labor interests within a given sector are expected to be identical because these factors are specific to the sector.

rates because currency volatility is associated with higher risk and transaction costs (Frieden 1991: 444–45). But on the other hand, in his work with Stein (2001), Frieden argues that economies with large tradable sectors are more likely to employ a float (or backward looking crawling pegs) that allows competitive real exchange rates to be maintained because a fixed regime is associated with real exchange rate appreciation, which hurts the competitiveness of a domestic economy.[26] In this account, exporters seem to value a competitive depreciated currency associated with a flexible regime.

Frieden (1996 and 2002) tests the sectoral argument for a country sample including the Member States of the European Union (EU) and concludes that the single best prediction of their exchange rate policies in the post-1972 period was the degree of trade, financial, and investment integration with the EU. In other words, he finds that a high level of trade with the Deutsche mark bloc and an intra-EU trade and capital flows resulted in a higher degree of fixity of nominal exchange rates of European currencies against the Deutsche mark.[27] Yet we have not observed such a convergence toward fixed exchange rate regimes in EE countries with an equally high degree of trade and financial integration with Germany and with the euro-zone.

At first sight, focusing on the role of interest groups/economic sectors seems particularly appropriate for examining exchange rate policies in EE because institutional arrangements in the post-communist region, insulated from popular pressures during the most of the transition period, have rewarded narrow societal interests. Frieden's baseline model, however, cannot explain the variation of exchange

[26] Hazard models by Blomberg, Frieden and Stein (2005) indicate that countries with large manufacturing sectors are also more likely to abandon a fixed exchange rate. The authors find that a one percentage point increase in the size of the manufacturing sector is associated with a reduction of six months in the longevity of a country's currency peg.

[27] While Frieden (1996 and 2002) develops predictions for the choice of exchange rate regime, in his statistical model, he operationalizes his dependent variable as the annual rate of nominal depreciation and the annual coefficient of variation of monthly exchange rates (see chapter 3, Appendix 3). These are, however, not the measures of exchange rate regime choice but rather the measures of exchange rate movements or exchange rate level.

rate regimes in EE across countries and over time. While it identifies some important determinants of exchange rate regimes at the macro level, it operates with the assumption of the Anglo-American capital market-based financial systems. So, this model has a limited predictive ability for the transition or developing countries with strong, concentrated banking structures dominated by a few large banks, which play a significant political role. Therefore, sectoral analysis needs to be conditioned by the particularities of national institutional and historical development and capabilities.

More generally, interest group models do not specify a mechanism for selecting between powerful interest groups claiming governmental resources: they explain preferences for regime choice, rather than actual regime outcomes. Defining the preferences of manufacturing enterprises does not explain how these groups get their preferred economic policies. Frieden conceptualizes policy simply as the aggregate of private sector demands: sectoral characteristics determine the interests, the cleavages, and the balance of power among competing sectors. The state plays the role of a mere arbiter among competing interest groups. Nonetheless, policymakers are often able to dominate large industrial interests and extract rents from them. In fact, a sector's concentration in itself can be a product of the level and protection provided by the government. Thus, sectoral approaches to exchange rates advanced by Frieden, like the factoral models advanced by Rogowski (1989: 20) can predict general patterns of "cleavages," rather than the outcomes, for "victory or defeat depends both on the relative size of the various groups and on those institutional and cultural factors that [Rogowski and Frieden's] perspective[s] so resolutely ignores." Selection problem is thus a serious impediment in these models.

Furthermore, some argue that research on interest groups should pay more attention to the problem of insufficient collective action in monetary politics (Oatley 1997, Giovannini 1995, McNamara 1998). Exchange rates have broad distributional

consequences and are less excludable than trade policy (Gowa 1988).[28] In contrast, there are higher costs of collective action on the part of consumers and a large non-tradable sector and more free riding in monetary policy. The relative institutional insulation of the central bank from direct societal pressures also keeps interest group lobbying on exchange rates to a minimum. Moreover, most linkages between interest group pressures and exchange rate outcomes are not observable, and sectors "voice" their demands only when they expect to be effective or they pose credible threats.

Frieden's model succeeds in identifying preferences of producers and foreign direct investors, but it remains limited in its ability to account exchange-rate preferences of financiers, key actors in my theoretical framework.[29] Other scholars working in the tradition of interest group approaches explore the role of financial interests and systems in exchange rate policy. Although there is a recognition that banks can make profit under both fixed and flexible regimes, scholars tend to agree that banks prefer stable currencies, long time horizons, and monetary convergence under capital mobility, although for different reasons.

Hefeker (1997) and Cohen (1993) argue that large banks favor currency stability because monetary convergence leads to increase in total banking transactions. Henning (1994) goes further arguing that there is no constant relationship between preferences of banks and exchange rate regimes. Instead, bank preferences are often "ambivalent, weakly subscribed, and situationally dependent" (Henning 1994: 34). For him, the character of national financial systems and bank-industry ties further condition preferences of financiers: In the German and Japanese credit-based systems,

[28] All industries in the export sector benefit from stable currency. A small sector of tradable producers has also the advantage of prior organization and experience with lobbying for a particular trade policy.

[29] Although some scholars identify Frieden's "international investors" as banking/financial services, Frieden (1996) operationalizes this interest group in terms of foreign direct investors. For a full discussion of preferences of foreign direct investors in exchange rate policies, see chapter 2.

characterized by close institutional ties between banks and industries, pressures for competitiveness-conscious and stability-oriented exchange rate policies tend to be stronger than in the capital market-based U.S. financial system, in which the interest in maintaining domestic industry competiveness is dispersed among non-organized stakeholders and investors, and coordination on exchange rate policy is harder to achieve.[30]

What distinguishes Frieden's and Henning's approaches making the case for the strength of different sectors as determinants of exchange rate policy is the relative weight attached to sectoral preferences versus how institutional structures shape the varying policy influences of different interest groups and strategic choices of policy-makers. While Frieden's argument is more "society-oriented," Henning combines private-sector preferences and government institutions in explaining international monetary policies. The latter approach has much in common with institutionalist approaches that operate with the assumption that state institutions embody rules governing the relations and opportunities for building political coalitions between and among private interest groups and the state's economic policymaking bodies (Gourevich 1977).[31] In an effort to re-evaluate the interplay of institutional structures and bank interests in policymaking, this study nicely fits into Henning's agenda.

While these reviewed works focus on industrialized countries, Hall (2005) argues that in a middle-income developing country, when private banks provide most of the financing of enterprises and the country is open to international capital, banks often acquire dollar-denominated debt and tend to oppose abandoning a fixed regime. Based on Stallings' (1992) arguments about the influence of international capital on

[30] For Henning, the notion of "competitiveness" of exchange rates is consistent with stable or depreciating currency.

[31] For the institutionalist literature examining the organization of the private sector, bank-industry relationships, and the state, see Shonfield 1969, Katzenstein1978, Zysman 1983, and Gourevich 1986.

economic policy in developing countries, Shambaugh (2004) claims that countries with a greater dependence on foreign bank loans are more likely to maintain a fixed exchange rate, as devalued currencies increase the cost of loan repayment and flexible regimes increase the risks of non-repayment.

In defense of interest group approaches, the empirical reality in EE suggests that the politicization process may have moved from trade to exchange rate policy in the world of trade integration and capital mobility. In the domestic distributional game, trade and exchange rate policies are policy substitutes in terms of compensation benefits. International free trade agreements restrict the ability of governments to use trade policy, e.g., trade barriers or export subsidies, as a compensatory instrument for domestic interest groups, which may increase the saliency and the level *politicization* of exchange rate policy. As Henning (1994) argues, societal groups prefer external monetary remedies instead of trade protection because exchange rate increases advantages of competitiveness not only in the home market but also in the markets of foreign producers, and currency depreciation carries a smaller risk of foreign retaliation than trade protectionist measures.

Credibility and Institutions

The third main set of arguments emphasizes credibility-related considerations and the role of institutions. What unites the credibility and the OCA approaches is the principal trade-off between exchange rate stability and domestic monetary autonomy. The credibility argument is based on the idea that a country with a history of high inflation or previous failed attempts at decreasing inflation will have an incentive to adopt a fixed exchange rate as a nominal anchor to import the credibility of low-inflation policies from a foreign central bank (Giavazzi and Pagano 1988, Fratiani and von Hagen 1992, Alessina and Barro 2002). This view is based on rational expectation theories examining the time-inconsistency problem (rules versus discretion) in

monetary policy building from the premise that governments have the ability to use surprise inflation to generate short-term gains in output (Kydland and Prescott 1977, Barro and Gordon 1983).[32] The key to solving the time-inconsistency problem is credibility. The exchange rate provides a highly visible, easy verifiable target. It serves to increase the credibility of non-inflationary announcements and to reinforce a government's commitment to macroeconomic stabilization.

An independent central bank has been identified as an alternative source of credibility. In this view, fixed exchange rates and independent central banks are considered to be alternative ways to increase the credibility of anti-inflationary announcements and to reduce the inflationary bias in monetary policy (Bernhard, Broz, and Clark 2003). An independent central bank, with price stability as its primary goal, should thus reduce the government's need to resort to fixed exchange rates. By establishing an independent central bank that enables a government to credibly commit to low inflation and currency float at the same time, the government can escape the traditional problem of delegation-credibility versus flexibility. Notwithstanding, Eichengreen and Leblang (2003) show that over the longer historical horizon, the opposite relationship seems to hold: countries with independent central banks are more likely to peg. There is also a discord about which institution is a more efficient anti-inflationary device.[33]

[32] The logic of the time-inconsistency approach is as follows: policymakers renege on their promise of low inflation policies to achieve short-term improvements in real economic outcomes, such as growth and employment. Because private actors anticipate this behavior, the attempts of policymakers to create inflationary surprise will be neutralized and the economic outcome will be higher inflation without additional output. Therefore, rational expectations of private actors introduce an inflationary bias into wage bargaining and price setting. For a review of this literature, see Persson and Tabellini (1994).

[33] For example, Keefer and Stasavage (2002) argue that a currency peg is a more efficient anti-inflationary device than an independent central bank when it is hard for the public to ascertain the sources of inflationary pressures.

Broz (2002) extends the logic of time-inconsistency by arguing that credible commitment to low inflation requires transparency to detect and punish government opportunism. In his framework, governments in authoritarian systems with opaque decision making will favor transparent commitment technologies, and thus a fixed regime to assist in engendering expectations of low inflation. In contrast, in democracies, where political decision making is transparent, legal central bank independence can produce low inflation. In a similar vein, others argue that authoritarian governments may also be better able to sustain a peg because they are more insulated from domestic politics and thus bear lower political costs for pegging (Leblang 1999, Haggard 1990). In addition, pegs are often established by the executive branch of government alone without legislative approval (Keefer and Stasavage 2002: 757). It has been shown that, historically, democratization and the associated expansion of suffrage create pressures for redistributive policies, thereby reducing policy makers' ability to defend the value of currencies. The "compensation" thesis suggests that democracies that face greater societal pressures to trade exchange rate stability for other goals, such as the reduction of unemployment, are more likely to choose flexible rates (Eichengreen 1992, Simmons 1994).[34] Thus, non-democracies are alleged to be more likely to adopt fixed rate regimes, although the causal mechanism behind this correlation is still debated.

Despite the widespread currency of credibility-based reasoning, the difficulty with this approach is that it assumes that the fight against inflation is the only goal of exchange rate policy. Governments can also use exchange rate to promote domestic export industries or distribute rents to their cronies. In addition, its underlying premise

[34] The sensitivity of government to these pressures is likely to be stronger in more democratic countries because democratization increases the availability of information and the transparency of the political process, while it decreases the transaction costs of political organizations of interest groups vulnerable to international capital and trade flows (Alesina and Rosenthal 1995, Bernhard and Leblang 1995).

is that all governments and their constituencies have the same level of tolerance for inflation. As I will show in subsequent chapters, transition countries demonstrated different interests and capability to fight inflation. Although the belief in the efficacy of exchange rate as a nominal anchor for disinflation purposes dominated the thinking of policymakers and external advisors at the beginning of the transition, only a few EE governments adopted exchange rate stabilization programs despite experiencing high inflation. And many of them have used both institutions—independent central bank and currency peg—to stabilize their economies. Finally, merely fixing the exchange rate does not solve the credibility problem because a weak government is likely to take its commitments back rather than carry sustainable policies.

Systemic Explanations

So far, the theories we have considered are domestic. But one further set of arguments underlines the influence of international factors.[35] Mundell (1961) and Flemming (1962) extend the OCA theory to allow for capital mobility. Capital mobility, i.e., the ability of investors to move their capital across national borders, is considered to be a structural feature of the international system, constraining governments by determining the costs and benefits of their economic policies (Andrews 1994, Webb 1995). According to the open-economy macroeconomic *Mundell–Flemming* framework (also referred to as the "holy trinity") in a world of high capital mobility, nominal exchange rate pegs cannot be sustained without giving up independent monetary policy.[36] Therefore, a country can attain only two of these

[35] The argument is that international factors influence economic policies of governments by restricting the set of feasible policies, by putting constraints on domestic institutions, or by changing the preferred policies and behavior of domestic actors. For the literature on internationalization of finance, see Cohen (1996), Keohane and Milner (1996).

[36] In the context of the EU, Padoa-Schioppa (1994) warned against efforts to pursue an "inconsistent quartet" of policy objectives: free trade, full capital mobility, fixed exchange rates, and independent national monetary policies. For him, the only solution to this inconsistency was to complement the internal market with a monetary union.

three goals: domestic monetary policy autonomy, fixed exchange rate, and capital mobility.[37] Therefore, when the exchange rate is fixed, increased capital mobility reduces the effectiveness of monetary policy but enhances the effectiveness of fiscal policy.[38]

More recently, it has been argued that as financial globalization deepened, monetary policy became increasingly incompatible with fixed exchange rate regimes. After the currency crises in emerging markets in the 1990s, which involved combinations of some form of fixed regime with high capital mobility, a bipolar view or "hollowing-out" hypothesis has emerged according to which, in the current international environment of mobile capital, countries are left with two corner solutions: hard currency peg (currency board, dollarization, currency union) or free floats (Eichengreen 1994, Obstfeld and Rogoff 1995, Fisher 2001). As Eichengreen (1994) explains, countries can use three policy instruments to contain market pressures: capital controls, interest rates, and international borrowing. Because investors can increasingly circumvent capital controls, high interest rates can lead to higher unemployment, and foreign borrowing may come with intolerable conditions. As capital mobility increases the costs of containing market pressures, the government's promise to defend the peg becomes less credible and more prone to

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[37] Obstfeld and Taylor (2002) conclude that historically, while capital mobility prevailed in the gold standard system when monetary policy was subordinated to exchange rate stability, as soon as countries attempted to use monetary policy to revive their economies in the interwar period, they had to impose controls to curtail capital movements.

[38] The Mundell-Flemming model holds that the choice of the optimal exchange rate should depend on the type of shock hitting the economy: if shocks are predominantly real, a flexible regime is optimal, whereas if shocks are monetary, a fixed regime is desirable. The model assumes imperfections in goods markets, i.e., sticky prices, but undistorted capital markets, i.e., perfect capital mobility. Lahiri, Singh, and Vegh (2006), however, note that in developing countries, financial markets are underdeveloped, and thus financial market frictions are equally, if not more important, than goods market frictions. The authors suggest turning the Mundell-Flemming dictum on its head: flexible rates are optimal in the presence of monetary shocks, whereas fixed rates are optimal in response to real shocks.

speculative attacks. Thus, pegs and intermediate regimes may increase the risk of currency crises under high capital mobility.[39]

The hollowing out hypothesis explains the consequences of the decision to adopt a fixed regime, but does not determine why countries choose to maintain or abandon it (Hall 2005: 18–23). Ultimately, then, the Mundell-Flemming model does not determine what choices of exchange rate regimes governments make. It only identifies economic costs associated with different exchange rate regimes (Hall 2005: 16). Moreover, empirical studies have shown that many emerging market and developing countries have pursued hybrid or intermediate regimes between rigid pegs and full floats (Poirson 2001).[40] Similarly, as I will show in chapter 4, intermediate regimes have played an important role in exchange rate policies in the transition economies. In sum, while international capital mobility certainly imposes certain constraints on policy goals of national governments, e.g., inflation, governments do not simply react to international conditions. Governments seem to retain a room of maneuver in terms of the policy instruments, e.g., as interest rates, when properly coordinated (Bearce 2007).[41]

Other scholars recognized the importance of the international political dimension of exchange rate regime policies.[42] One type of explanation of international

[39] Obstfeld and Rogoff (1995) argue that pegs have limited credibility under capital mobility because there are limits to the amount of monetary policy autonomy countries are willing to forgo to maintain pegs. Fisher (2001) warns that limited effectiveness of capital controls and sterilized interventions make pegs unsustainable under capital mobility.

[40] The empirical work testing the Mundell-Flemming theory yields inconclusive results. See Shambaugh (2004), Obstfeld, Shambaugh, and Taylor (2004), Calvo and Reinhart (2002).

[41] This argument is in line with the writings on globalization stressing that states retaining some autonomy over economic policy explain the diversity of economic policies across countries despite globalization. See Garret and Lange (1995), Garrett (1998), Mosley (2000).

[42] I would like to stress that this study focuses on the national exchange rate policies, i.e., the choice of exchange rate regime rather than on the international monetary regime, i.e., the degree to which currencies are fixed against one another. Although national policy choices depend on the character of

influence stresses the importance of the anchor country, a dominant state willing to use its monetary leadership to make a fixed regime sustainable. According to the so-called hegemonic stability theory, the (economic and political) strength and engagement of the anchor country—the hegemonic power—performs the function of lender of last resort for the financial system or in balance of payment crises plays a crucial role in sustaining policies of hard pegs (Kindleberger 1986).[43] Although the theory provides an important insight in explaining monetary cooperation in the Bretton Woods system, it is difficult to extend it to a regional context. The theory is ambiguous over the nature and the exercise of power and it lacks micro-foundations for understanding the benefits and costs of monetary cooperation to a hegemonic power (McNamara 1998).[44] For example, it has been argued that in spite of high trade integration, the CIS ruble zone collapsed in part because Russia was no longer a viable economic anchor: Moscow was no longer providing the public goods needed to stabilize the common monetary area (Odling-Smee and Pastor 2001).[45] In fact, Russia itself dissolved the ruble zone in the summer of 1993. The decision to fix also involves a broader issue of policy dependence with respect to the policies of the anchor country and can impact a country's conception of its national sovereignty.[46]

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the international monetary system, these are two different dependent variables analytically. See Broz and Frieden (2001).

[43] Hegemonic stability theory was made famous by Kindleberger (1986), who interpreted the collapse of the international system during the 1930s as a breakdown in international leadership.

[44] In regard to the European Monetary System (EMS), Fratiani and von Hagen (1992: 68) point to the lack of clarity on explaining German membership in the system.

[45] For alternative interpretations of the ruble zone collapse, see Abdelal (2001) and Pomfret (2001).

[46] For example, the members of the CFA zone experienced deflationary effects of pegging to the French franc when France pursued the policy of the franc fort to fulfill the EMU convergence criteria (Fouda and Stasavage 2000).

The level of broader political ties with the anchor country and level of shared political engagement and mutual interdependence among the countries with fixed regimes can substitute for the lack of hegemonic strength or domestic political weakness (Cohen 1994).[47] An argument often employed to explain the commitment of European countries to fixed regimes identifies "European integration" as the major driving force: fixed exchange rates are a purely European phenomenon, driven by politics rather than economics (Garrett 2000). Alternatively, Gruber (2000) argues that monetary integration in Europe has as much to do with power, cooptation, and domination as with bargaining or strategic interaction. For him, the European Monetary System was imposed by a Franco-German coalition (the "agenda setters"), while other countries, which would have preferred flexible regimes, like Italy, joined the system of fixed rates because the price of being left out, e.g., negative signals to financial markets, was greater that the price of entry.[48] There is a near consensus in the post-communist studies that the EU is the most influential external actor in the accession/new members countries from EE. Yet, despite the homogeneous EU pressures in various economic policy areas, the EE countries, proclaiming the EU and European Monetary Union (EMU) accession of the primary foreign policy goal, have pursued different exchange rate regimes.

One further argument rests on the role of the International Monetary Fund (IMF) in promoting currency boards in order to fill the "credibility deficit" that confronts economic policy making in emerging market countries and to assure foreign

[47] Henning (1998) argued that European countries most effectively coordinate their exchange-rate and monetary policies when the United States acts in a manner that creates instability and negative externalities.

[48] Numerous studies that have examined Germany's role in European monetary integration falls into two categories: those that focus on the geopolitical drives of German policy and those that focus on domestic economic interests. See Kaltenhaler (2002), Kaelberer (2001).

investors that governments will not reverse neoliberal economic reforms (Grabel 2003).[49] Of course, international interactions will shape government policies toward exchange rate regimes, but the challenge is to specify the relative weight of these international effects with domestic influences when faced with divergent policies of trading partners or neighboring countries.

Normative Arguments for Fix and Float

I would like to specify what this study is *not* about. First, it is a positive description of the choices made rather than a *normative* model of what the optimal exchange rate regime should be.[50] Second, this study does not examine the effects of exchange rate regimes on economic growth. I do take the impact of regime choices into account but indirectly, by linking the current regime choices to the economic and political performance under previous regimes.

Therefore, this research has not been directed at the normative debate surrounding the choice of exchange rate regime, the questions of whether or not states *should* be pegging or floating. The normative question revolves around weighing the costs of one exchange rate regime choice relative to the costs of the others. There is little consensus in the literature on the welfare criteria for the exchange rate regime choice. Here, I quickly review strengths and weaknesses of fixed and flexible regimes. Table 1.1 summarizes the traditional arguments on exchange rate regime choice.

A fixed exchange rate is an effective nominal anchor for monetary policy. Countries frequently adopt fixed regimes for domestic monetary (price) stabilization. The commitment to fixed exchange rate facilitates disinflation. Restrictions imposed by the objective of maintaining fixed regimes disciplines policy makers and

[49] There are those who focus on learning and the network effects of fixed regimes (Simmons and Heinmueller 2004).

[50] This study does not attempt to estimate the equilibrium exchange rate, which requires different estimation techniques.

discourages their propensity towards erratic policies, e.g., monetary financing of a fiscal deficit. Fixing, therefore, reduces the probability of banking and financial crises (Eichengreen and Rose 1998). Fixed regimes also allow countries with weak monetary institutions to import monetary credibility by anchoring a national currency with a reputable central bank of the anchor country.

Furthermore, fixed regimes are associated with currency stability. Fixing limits exchange risks for cross-border exchanges and foreign investments facing exporters and importers, international borrowers and lenders, so it reduces the costs of international trade. Trade openness is the key parameter determining the importance of the advantages of fixed regimes (Frankel 1995). Last, fixed regimes have also been used for ambitious political integration goals, such as European monetary unification.

In a fixed regime, however, there is no scope for monetary policy to have independent effects. Governments are not able, without abandoning the parity, to use the exchange rate as a policy instrument to deal with domestic macroeconomic problems and to affect the competitiveness of domestic industries.[51] Governments cannot devalue in the face balance of payment deficits or decrease short-term interest rates in a recession. Fixed regimes also reduce the ability of government politicians to respond to distributional pressures of interest groups, e.g. exporters, their constituents, for supportive policies (Broz and Frieden 2001, Bernhard, Broz and Clark 2002).

[51] A country's competitiveness can be sustained through wage and price adjustment (in the case of a fixed regime) or exchange rate adjustment (in the case of a flexible regime).

Table 1.1: Arguments in Favor of Fixed versus Flexible Exchange Rate Regime

	FIXED REGIME	*FLEXIBLE REGIME*
ADVANTAGES	Limits the exchange risk for international transactions and foreign investments→more trade and capital flows. Decreases cost of access to international financial markets→lowers risk premium. Decreases domestic interest rates→reduces spread with the world market interest rate. Decreases inflation. Impedes monetary financing of the fiscal deficit. Credibility import from the anchor country.	Neutralizes the effect of inflation on export competitiveness. Allows exchange rate adjustments to stimulate domestic demand and competitiveness. Neutralizes the impact of external shocks.
DISADVANTAGES	Dependence on the monetary policy of the peg country (sovereignty issues if hard pegs). Real exchange rate appreciation and current account deficit→negative effect on national competitiveness. Less maneuvering room for dealing with the balance of payments deficits. Less ability to affect domestic price competitiveness.	Source of imported inflation. Negative effect of strong volatility on trade and financial transactions. A source of regional instability if competitive devaluations. Postponement of required structural adjustments.

Source: Poirson (2001: 26), Edwards and Savastano (1999), Bernhard, Broz and Clark (2002).

A flexible regime allows the use of exchange rate as a policy instrument against economic problems, such as unemployment or economic recession. However, currency floats lead to exchange rate volatility, and therefore less trade and fewer capital flows. The use of competitive devaluations to promote domestic industries can even lead to risking international retaliations.

Methodology and Organization

The chapter has reviewed the principal predictions from existing theories that provide the most likely explanations of why some countries are willing and able to commit to sustainable policies of fixed exchange rates, while others are not. I argue

for a change in the way we think about exchange rate politics, placing greater emphasis on different types of banks, differentiated by the nature of their ownership and their interests. The main exercise in this study is empirically testing this new approach. I conclude this chapter by briefly discussing the research design and methodologies I use to evaluate the theory, and laying out the plan for empirical analyses in the remainder of the dissertation. These empirical tests all contribute to the central aim of the thesis: *understanding and documenting exchange rate policy making from interest groups, through institutional structures, to outcomes.*

In Chapter 2, I outline the first dimension of the finance-based perspective more fully, while first exploring the sources of political influence of different types of financiers and identifying their interests and strategies in exchange rate, monetary, and regulatory policies.

In Chapter 3, I examine the second dimension of my theory by examining how the chosen method of bank privatization (and industry privatization) and financial liberalization shaped the institutional variation of national systems of finance in EE. This chapter presents a novel typology of financial systems that emerged in the post-communist region after the collapse of communism.

Next, I evaluate the proposed theoretical argument by pursuing two approaches in empirical analysis: statistical analysis and comparative cases. This dualistic methodological approach has several advantages in explaining such a complex phenomenon as exchange rate policy. The quantitative analysis shows the importance of the relative influences of several variables, which is harder to do convincingly using a small number of cases. Nonetheless, there are some problems in performing quantitative analysis of economic policies in EE, including data restrictions for some countries and some years and short time series of data. Given the scale of the changes

in EE after the collapse of communism, there might also be a lot of "noise" in the regressions (Hallerberg and de Souza 2002).

To perform a quantitative analysis, I will deduce policy preferences of groups for particular policies on the basis of economic theories and empirical literature. One important shortcoming of the deductive approach of determining preferences is that it sometimes relies on the economic theories that are themselves controversial (Frieden 1999). As Giovannini (1995) maintains, there is little agreement among economists on a "benchmark" model for examining the distributional effects of different currency regimes. Moreover, economic models have not yet produced consistent hypotheses regarding the economic interests in favor of fixed versus flexible regimes, so the economic effects of an exchange rate regime depend on the particular institutional setting and economic conditions in a particular period of time. In order to address this deficiency of deductive reasoning, I will complement my statistical analysis with an observational or inductive approach to ascertain currency preferences of societal groups by observation and field interviews in the four countries under close examination in this study.

In Chapter 4, I develop a quantitative model testing the effect of different financial institutional structures on the choices and sustainability of their exchange rate regimes on cross-section, time-series data on 25 transition economies in EE between 1990 and 2004. The empirical goal of statistical analysis is to confirm the independent and the contributory effects of financial interests and institutions, while controlling for other potential determinants of exchange rate regimes.

Chapter 5 traces the evolution of exchange rate regimes in EE countries during the post-communist period. I offer a broad assessment of exchange rate policy-making patterns in all 25 countries of EE during two phases of economic development—stabilization and post-stabilization—while also exploring initial conditions at the

outset of the transition. This chapter goes beyond chapter 4 by examining the reasons behind the discrepancies between the official and actual choices of governments in regard to exchange rate regimes.

The mechanisms and concrete political processes, through which interest groups influence exchange rate policies via intermediation of financial institutional structures, are traceable in in-depth studies. To examine the causal mechanism that I suggest in detail, I employ a comparative case method by tracing the processes of exchange rate policy making in four countries–Bulgaria and Estonia (chapter 6), the Czech Republic (chapter 7), and Poland (chapter 8) –with a special emphasis on variation in the financial ownership structures, institutions, and processes by which these policies were conducted. A limited number of cases allows for a detailed analysis of the causal flow of events and for a systematic examination of similarities and differences. Detailed country studies allow assessing causal complexities and the importance of sequencing and timing. I develop a sequential narrative in support of the theoretical argument.

Through the process tracing, these chapters seek to evaluate the mechanisms through which the theory expects exchange rate policy to be determined (King et al., 1994, Brady and Collier 2004). By developing a more complete picture of financial development and exchange rate policy making over time, I attempt to reduce the risks of selection bias. These chapters are based on evidence about the content of societal debates drawn from newspapers, archival sources, and field research. Such field research entails detailed journalistic accounts and 105 interviews with policy makers at these countries' central banks, Ministries of Finance, Economy, and Privatization and other government officials, commercial bankers, company analysts in investment funds, investment funds, and academics.

I selected these cases because they represent a variation on both dependent and

independent variables. These countries also represent the paradigmatic types of financial systems in EE—capture, collusion, competition, and consensus—that have produced a different set of exchange rate policy outcomes. While Bulgaria and the Czech Republic represent the possible variations on a clientelistic financial system, Poland and Estonia exemplify open systems. Because each typifies one of the patterns of post-communist institutional structures of finance, together they cover the full range of the behavior I try to explain in this dissertation. Their politics shared one similarity: each of these four states was aspiring to become a member of the European Community. Yet, the governments of these countries pursued divergent policies in the areas of money and finance.

Bulgaria and Estonia are extreme cases of financial systems. Before 1997, Bulgaria had privatized none of its banks, so it preserved a crony institutional environment in which incumbent banks and enterprises were able to capture the government as well as the central bank. The government let the exchange rate float because it lacked the political ability to enforce unpopular policies required to defend a peg. Only after devastating crises in 1996–1997, a currency board was installed to tie the hands of the Bulgarian government. In contrast, Estonia has arm's-length connections between banks and industries and an independent central bank. The government was able to constrain the influence of incumbent networks by liquidating and selling nearly all of the country's SOBs to foreigners. A competitive financial system allowed the government to sustain the hardest form of exchange rate regime (a currency board) throughout the transition.

The Czech Republic and Poland are intermediate cases of financial systems. The financial system in the Czech Republic, the outcome of voucher privatization, was one of collusion between large incumbent banks, industries, and the state linked by extensive cross-ownership. Still, the Czech central bank was able to build a reputation

as a credible and independent institution able to sustain a fixed exchange rate for an extended period of time. An inconsistent policy mix between the anti-inflationary monetary policy of the central bank and the expansive fiscal policy of the government promoting the interests of incumbents led to a collapse of the currency peg in 1997. The eclectic Polish method of bank privatization through public offers and sales to foreigners resulted in a depoliticized bank-industry relationship. The central bank, however, was much less independent from the government, and the policy pattern was a consensual exchange rate policy making with the objective of sustaining the competitiveness of domestic industries through the use of various soft pegs.

The last chapter summarizes the theoretical and empirical analysis and outlines a general framework about the political economy of exchange rates. Having established the role of different types of banks in exchange rate regime determination, this chapter also introduces some speculations and future avenues of research regarding foreign ownership in finance. A graphic contemporary example of the controversial role of foreign investments is the emergence of the sovereign wealth funds used by governments of authoritarian countries to acquire strategic stakes in developed countries, often in a non-transparent way.

CHAPTER 2

THE FINANCE–BASED THEORY OF EXCHANGE RATE POLICY

The introductory chapter laid out the broad outline of this study whose general theme is the role of financial institutions in exchange rate policy. I identified the perplexing empirical phenomenon of exchange rate policy variation in transition economies, which raises a question about the economic and political determinants of the choice and sustainability of exchange rate regimes. The focus of this dissertation is on whether it is possible to identify the *structures* and *institutions* that make the choice of a fixed exchange rate arrangement and its sustainability more likely. The key insight of the argument is that financiers shape government decisions regarding exchange rate policies through financial institutional structures in several specific ways.

The review of the existing literature revealed that empirical and theoretical gaps exist in our understanding of exchange rate regime choices. None of the competing schools of thought has offered a plausible explanation of exchange rate diversity in transition economies that accounts for the role of financial linkages. This study concentrates on the implications of the roles state-owned, private, and foreign financiers play in exchange rate regime choice and sustainability. I demonstrate that bank ownership does matter in macro-economic policies.[52]

To date, the conventional wisdom has posited financiers as a homogenous societal group that is uniformly conservative, inflation-averse, and supportive of monetary stability. In contrast, I argue for a more nuanced view of financiers that

[52] This argument diverges from recent institutional literature that emphasizes the primacy of institutions in macroeconomic policies (Acemoglu et al. 2003). I do not dispute the importance of institutions, but I treat them as *endogenous* to exchange rate regime choices rather than as exogenous. Therefore, in my framework, ownership precedes institutions.

emphasizes their diverging interests in monetary, exchange rate, and regulatory realms influenced by the nature of their ownership. I develop my finance-based theory of exchange rate choice and sustainability in two chapters. In this chapter, I develop one dimension of my theory by examining the interests and behavior of state-owned, private domestic and foreign banks' exchange rate, and monetary and regulatory policies. Before turning to this analysis, I begin by presenting a full finance-based model of exchange rate regime choice and sustainability. Next, I explore the role and power of financiers in the economy and how the economy is influenced by the nature of their ownership. Subsequently, chapter 3 places the main argument in the context of recent research on finance and growth and traces the origins and development of financial systems in EE by exploring the role of bank privatization and various modes of state divestiture in financial development. I also present a novel typology of financial systems in EE.

The Logic of the Finance-Based Perspective

Figure 1 illustrates the logic of my finance-based argument. First, I begin with the premise that banks are powerful economic interests, with political power to exert pressure on government to adopt policies and legislation that suit their interests as a result of their market power, their organizational advantages, and their important role in the economy. Second, the interests and policy consequences of bank behavior in exchange rate policies vary depending on the nature of ownership. Bank ownership can take three forms: state-owned, private domestic, and foreign. Banks can influence exchange rate policy directly or indirectly through their impact on monetary and regulatory institutions and policies. Third, the structure of ownership in a country's financial system empowers different types of banks, shapes the responsiveness of government politicians to bank demands, and mediates the demands and behavior of financial interests. Finally, the structure of ownership in a financial system influences

the subsequent building of monetary and regulatory institutions that determine the ability of government to commit to a sustainable fixed exchange rate regime aimed at economic development.

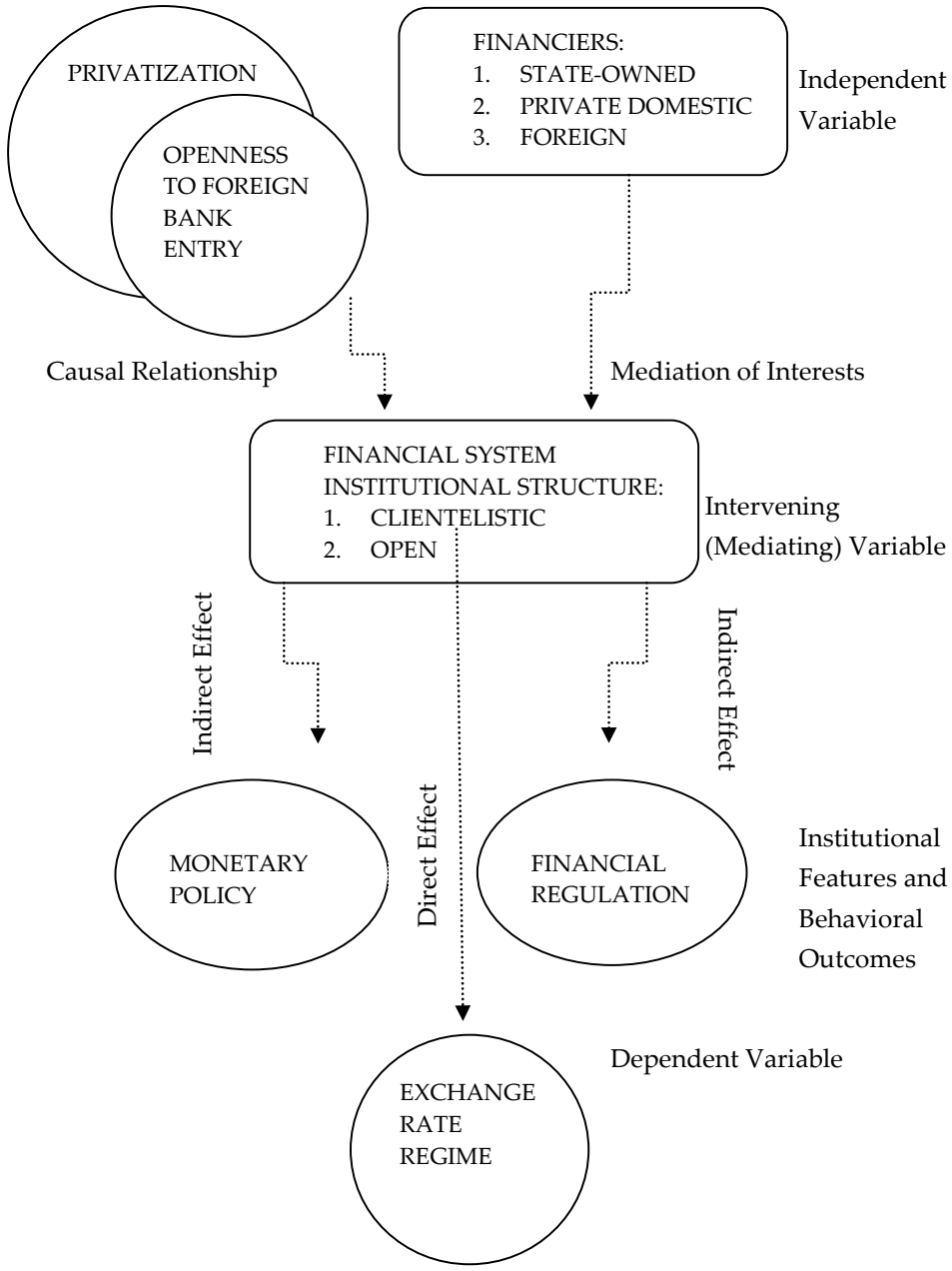

Figure 2.1: Causal pathways

I argue that financial institutional structures dominated by state-owned banks (SOBs)—which I dub *clientelistic*—are conducive to inflationary connected lending, lax banking supervision, and weak prudential regulation. State ownership, "financial repression," and closure of the financial system to foreign entry place the decision-making authority in the exchange rate policy area in the hands of the incumbent political elite who lack incentives to build strong institutions that would change the "oligarchic" structures of power.[53] SOBs preserve close links with the political elite that become political channels through which to obtain their preferred economic policies, which may not be compatible with the general public good. These banks benefit from weak institutions rather than demanding institutions that would limit the discretionary power of the political elite. State ownership also undermines the entry of new private domestic banks powerful enough to challenge incumbent networks or to reinforce the institutions.

Weak regulatory institutions allow the entry of new private banks, which are also linked to the political elite and state-owned enterprises through ownership and politicized relationships. Thus, the interests and behavior of such newly created private banks tend to converge with those of SOBs. In such weak institutional settings, governments lack the political incentives, ability, and political support to commit credibly to low inflation and low public debt to make their pegs sustainable and resistant to speculative attacks. Incumbent influence is likely to result in expansive credit and fiscal policies, a monetary policy of high inflation, and costly bailouts that reduce the general welfare of the population. SOBs favor the monetary autonomy associated with a flexible regime that allows governments to define interest rates and expand the money supply. Therefore, governments have the incentive to let the

[53] Acemoglu and Robinson (2006: 329) define an "oligarchic structure" as one in which "a group of agents monopolize political power and is difficult to displace the entrenchment afforded to them by the political institutions."

exchange rate float, or they are forced to devalue currency and abandon pegs in the face of such large economic shocks as banking and financial crises that have rendered previous regime choices unviable.

For institutional structures in finance characterized by a strong foreign bank presence—which I call *open*—governments are more likely to promote policies that are consistent with international banks. The entry of foreign banks fosters competition and weakens the political influence of SOBs and their enterprise clients. It also creates a new set of domestic private banks with the potential to demand that institutions limit the discretionary influence of incumbent rent-seeking networks among banks, industries, and the state. Foreign banks have a vested interest in demanding strong institutions that will protect their property rights and stabilize their profits. The incumbent political elite may have incentives to build stronger institutions that cater to the interests of foreign investors and private domestic banks, enabling the elite to regulate and extract profits from the banks. International banks favor financial liberalization and the monetary integration of fixed rates in order to profit from cross-border operations. They may also discipline the host country's monetary and fiscal policies and thus enable governments to commit to and sustain anti-inflationary and stability-oriented exchange rate policies aimed at economic stabilization and growth.

The principal hypothesis that is tested in this study is that in countries with financial systems dominated by SOBs and that are accompanied by weak monetary and regulatory institutions, their governments will lack the political support, willingness, and credibility to commit to and sustain a fixed exchange rate regime. The likelihood of this regime should be correlated with an increase in the presence of foreign banks in national financial ownership and institutional structures. Financial and institutional structures, in which financial interests compete for influence over economic policy-making, represent a critical intervening variable that link these

interests to exchange rate policy. Financial systems in EE are, in turn, the outcomes of financial openness to foreign entry in the banking sector through privatization. This causal link is examined in chapter 3 of this study.

The argument made here builds on political economy theories that highlight the role of finance in exchange rate regime choice.[54] To develop my argument, I draw together insights from two additional analytic traditions, the first of which is finance-growth literature examining government participation in finance and the role of foreign banks. It has been consistently shown that while widespread state ownership of banks is associated with underdeveloped financial systems and slower economic growth (La Porta et al. 2002, Barth, Caprio and Levine 2000, Caprio et al. 2004), the entry of foreign banks has mostly positive effects on financial development in developing and emerging countries (Detragiache et al. 2006, Goldberg 2004). Second, I draw on the literature that focuses on the effects of the moral hazard of governmental guarantees and balance-sheet bank problems inherent in the financial crises in emerging markets (the "third generation" models of currency crises) (Krugman 1998, Chang and Velasco 1998, Eichengreen and Hausmann 1999).[55] The literature on financial crises developed in response to a different question yet is closely related to the exchange rate regime choice literature: If a change in one of the explanatory variables increases the probability of a currency collapse, it also influences the probability of a change in the exchange rate regime.

[54] Recent empirical studies examining the role of financial development in regime choice include Aghion et al. (2006), Von Hagen and Zhou (2005), Levy-Yeyati et al. (2007), Calvo and Reinhart 2002, and Domac and Martinez Peria (2000).

[55] The first generation of currency crisis models underlines the role of weak economic fundamentals, such as excessive expansionary fiscal and monetary policy (Krugman 1979). The "second generation" models seek to explain the crisis of the European Monetary System in the early 1990s. The focus is on the effects of countercyclical policies in developed economies and on self-fulfilling crises, with market rumors unrelated to macroeconomic fundamentals (Obstfeld 1994). In contrast, Kindleberger's 1989 historical overview of financial crises focuses on the instability of expectations, speculation, credit expansion, and financial need that lead to crisis, panic and collapse.

One of the main objectives of this chapter is to delineate how and why the interests and behavior of banks vary by the nature of their ownership and the sources of their power to influence government politicians. Subsequent sections, in turn, explain the building blocks of the theory.

The Power of Banks

Why would governments respond to the demands of financial interests in economic policymaking? Because of their market power, organizational advantages, and important role in the economy, banks are powerful economic interests with the political power to exert pressure on politicians to adopt policies and legislation to suit banking interests. As holders of liquid assets, financiers have structural power over the state to influence major political and economic decisions, and that has been established historically.[56]

The principal source of the power for banks stems from their critical role in the economy. As early as 1912, Schumpeter suggested that through funding selection for entrepreneurs, banks can promote innovative activity and enhance economic development. Well-functioning banks that provide credits to the best projects, rather than to those with political or family connections, contribute to a more equal distribution of income and economic growth (Beck, Demirguc-Kunt and Levine 2004).[57]

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[56] The European monarchs had given financiers a greater voice in policy-making as compensation for acquiescing to taxation. More recently, the House of Morgan, "much like the old Rothschilds and Barings, seemed insinuated into the power structure of many countries … the old Morgan partners were financial ambassadors whose daily business was often closely intertwined with affairs of the state" (Chernow quoted in Johnson 2000: 14).

[57] The advantage of banks over individual investors stems from their ability to solve the problem of *asymmetric* information between enterprises and their potential sources of finance. Asymmetric information creates two types of problems that impede the allocation of capital to its most productive use. Before a transaction is completed, *adverse selection* occurs and increases the probability of bad credit risks. As a consequence, lenders may decide not to make any loans at all, even though there are good credit risks in the market. After a transaction, asymmetric information leads to a *moral hazard* problem, which is the risk (hazard) that the other party will engage in activities that decrease the

Banks thus have important leverage over enterprises. This leverage is particularly strong in countries with underdeveloped capital markets, where the quality of information is opaque and it is harder for enterprises to issue equity or bonds as sources of financing (Mishkin 2006: 31).[58] Banks allow these enterprises, which are often unable to operate on international capital markets, to access funds at prices and conditions not available to them outside bank finance (Hall 2005: 33).

Second, financiers have a strong leverage over the governments. Banks serve as channels, through which monetary policy affects the real economy. Banks buy government bonds issued to finance fiscal deficits. Government bonds represent a profitable risk adjusted investment alternative for banks (Maxfield 1991).[59]

Banks also have important private information on the health of the financial system and on the exact consequences of exchange rate policy (Hall 2005: 170). Banking crises and bank closures are associated with high fiscal costs and severe economic disruptions,[60] so governments and central banks are sensitive to the situation and needs of banks, providing them with opportunities to influence economic policy-making. In most countries, commercial banks have close institutional ties to ministries of finance and central banks, that is, institutions in charge of monetary and exchange

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probability that the loan will be paid back. Banks can efficiently diminish asymmetric information problems through screening, monitoring, and collateral. This discussion of the principal-agent problem in finance is based on Mishkin (2006) and Fohlin (2007).

[58] The flow of poor information exposed financial systems of EE economies to problems of moral hazard and insider dealing on a huge scale (Berglof and Bolton 2002: 1).

[59] In EE states, government debt has mostly been intermediated by banks: government securities represent the main portion of bank securities portfolios. Bank consolidation programs also allowed swaps of bad loans, accumulated by banks, for government bonds. In Bulgaria, Hungary, Lithuania and Slovakia almost half of the banks, and in Poland more than 80 percent of the banks invest more than 10 percent of their assets in government securities (Von Hagen and Dinger 2005: 20).

[60] In the last twenty years, more than forty countries experienced banking crises, triggering losses that sometimes exceeded 50 percent of national income (Keefer 2006).

rate policies (Henning 1994, Maxfield 1991).[61] Furthermore, policy-makers are sensitive to banks for purely political reasons: banks can make large political campaign contributions and in bad times, bank failures can effectively be used in electoral campaigns (Ronsenbluth and Schaap 2003: 307).[62]

Finally, banks have a collective action advantage in organizing and overcoming free-rider problems in lobbying for preferred policies due to their market power and the concentrated nature of the banking system: a few large banks can organize more effectively to defend their interests than many diverse capital market investors or poorly organized depositors (Olson 1971).[63] Also, a small, concentrated group of bankers in the Olsonian sense has an easier time in bargaining over how to divide the costs of lobbying and to monitor a member's participation in lobbying (Olson 1966: 45–47).[64] In the next section, I will argue that the political influence of banks and the nature of bank-state interactions are significantly influenced by the bank ownership structure.

[61] Maxfield (1991) identified three conditions when economic policies will likely reflect the preferences of financiers: first, if the central bank is independent; second, if the finance ministry allies with the central bank and dominates economic policy-making; and finally, if the state has little ability to control investment financing.

[62] Johnson (2000: 1-26) identified four separate political roles of banks in democracies. Banks can act as interest groups, agents of government, patrons and clients of politicians, and (de)stabilizers of democratic polity.

[63] In most countries, the association of banks is the institutional and organizational basis for collective interests of the banking sector.

[64] The essence of the Olson's (1971) group paradox is that because of the free-rider problem, the larger the group to which they belong, the more individuals will tend to contribute lower levels of action (money, effort, time, etc.). There are two reasons for this: the larger the group, the smaller the perceived effect of an individual defection and the smaller the individual prize. Therefore, the free-rider problem makes smaller groups more effective in pursuing their common interests than larger groups.

The Ownership of Banks

According to the "political" theories of governmental participation in finance, the motivation of state bank ownership is to finance politically desirable projects without regard to economic viability in return for votes, political contributions, and bribes, resulting in a detrimental effect on economic growth (Shleifer and Vishny 1998, La Porta et al. 2002, Dinc 2005, Sapienza 2002, Andrews 2005, Caprio et al. 2004).[65]

State-owned banks (SOBs) are often explicitly or implicitly required to finance loss-making state-owned enterprises, to provide financing on noncommercial terms to regions or sectors, or to direct credit based on political connections rather than on risk assessment (Andrews 2005: 3). Directed lending is usually part of bargaining between the government and SOBs. For these incumbent banks, the key to lending ability is their relationship with those with influence over them, including managers, other lenders, suppliers, and political leaders (Rajan and Zingales 2003). SOBs benefit from governmental support and protections in the form of bailout guarantees, below market discount loans, and regulatory exemptions (Kroszner 1998).[66] In addition to the lobbying power enjoyed by banks in general, SOBs enjoy special privileges. As a result of the nature of their ownership, SOBs have better access to governmental officials and thus greater political influence on legislation and policies. Government banks suffer from the serious moral hazard problem of acting as both owner and

[65] In contrast, in the classic "development" view, originated by Gerschenkron (1962), governmental ownership of banks can stimulate growth where economic institutions are not sufficiently developed for private banks to play a development role. In its more recent, "social" version, SOBs are created to maximize broader social objectives by allocating funds to projects with high social returns and to less privileged groups and sectors, such as small enterprises, agriculture, and education (Stiglitz 1993).

[66] Interest rate subsidies provided to banks in EE ranged from 2.9 percent in Poland to 21 percent in Uzbekistan (de Melo et al. 1996).

regulator (Mian 2003).Their political power is particularly strong in concentrated banking systems, in which SOBs enjoy a monopolistic position in the market.[67]

In the absence of the profit motive, SOBs have little incentive to allocate their capital productively. Political interference and moral hazards stemming from soft-budget constraints[68] result in bad lending decisions, and high volumes of nonperforming loans that make a banking system financially fragile.[69] Evidence from EE confirms the view that governmental ownership of banks negatively influences financial and economic development. Many governments responded to powerful state-owned industrial lobbies and forced the "new" SOBs to act as quasi-fiscal agents of the state through interest rate controls or credit programs (Denizer, Desai and Gueorguiev 2006: 566–567). SOBs have thus taken on the role of the "old planning ministries" (Desai and Pistor 1997). On the other hand, being large and geographically concentrated, with monopolistic positions in deposit and lending activities, SOBs enjoyed considerable political influence in EE.

The privatization of SOBs to private owners enhances competition and changes the distribution of economic (and political) power on the financial market. *Private domestic banks* have higher cash-flow incentives and a greater distance

[67] The political influence of SOBs is greater compared with that of other state enterprises for several reasons. First, it is easier to disguise political motivation behind lending given the asymmetric information between banks and outsiders about loan quality. Second, the costs of political loans are revealed only at loan maturity. Third, banks are particularly desirable instruments for the distribution of political rents because the lending activities of banks influence all economic sectors. Finally, politicians can preserve their power by controlling financial resources more easily than through direct-entry barriers in other economic sectors (Dinc 2005, Andrews 2005, Rajan and Zingales 2003).

[68] Kornai (1980) examines the concept of soft budget constraint in centrally planned economies. Kornai, Maskin, and Roland (2003) further elaborate on this phenomenon in transition economies.

[69] A growing body of empirical literature shows that the widespread state ownership of banks is associated with underdeveloped financial systems, interventionist governments, low profits, high volumes of bad loans, poor protection of property rights, and slower economic growth (La Porta et al. 2002, Barth et al. 2000). State ownership tends also to be associated with a higher probability of financial instability and banking crises.

between regulator and ownership (Mian 2003). However, private banks in emerging markets, in particular, owner-managed banks, may be also prone to connected lending on noncommercial terms to family, close associates, or enterprises with which they have multidimensional ties (Mian 2003).[70]

In those EE countries where governmental ownership remained prevalent in banking, weak regulatory structures allowed the proliferation of new private banks that exhibited the same behavioral patterns as their state-owned counterparts. New private banks continued to operate as "agent" or "pocket" banks, created by ministries and other state bodies as well as by state-owned enterprises and industrial groups seeking access to cheap credit. In Russia, some banks came to be owned or controlled by oil producers, who used these "oil banks" to provide cheap credit to their shareholders and owners (Gnezditskaia 2005).

Domestic private banks in EE have been deeply involved in governmental activities: they channeled state credits to industries, participated in the financing of state programs, and mobilized savings to finance the state's internal debt (Sheriff et al. 2003). They benefited from the same sources of political power and privileges as SOBs, including access to cheap credit, protection from competition, and state guarantees. New private banks, which were not linked to enterprises by ownership, were often very small in size and could not influence financial policies in any meaningful way (Skosples 2006). Nor had they any political influence to pressure governments to improve the quality of regulatory and supervisory institutions that would prevent rent-seeking. Incumbent banks in EE—SOBs and private domestic—relied on lobbying based on particularistic contacts rather than on formal,

[70] In East Asia, family-owned and company-owned banks were found to be among the most risky, with excessive credit growth (Tschoegl 2003: 26).

institutionalized channels of representation through bank associations, particularly in the initial years of the transition (Frye 2002a).

The third type of banks is *foreign banks*.[71] Foreign banks foster competition in a host country's financial market where domestic banks are forced to operate more efficiently in order to survive.[72] Foreign banks are strangers to local interest networks and tend to be less politically connected domestically. Thus, they are less likely to be able to capture the government and more likely to resist governmental pressures for directed lending (Kroszner 1998, La Porta et al. 2002).

Foreign banks do not need to create coalitions, organize, or mobilize politically to lobby for their preferred policies. Because they are holders of mobile assets, their power resides in the highly credible threat to "exit" or their unwillingness to lend or invest in a host country (Hirschman 1970, Maxfield and Haggard 1996). Under the conditions of increased financial integration, the bargaining power of mobile capital increases as it can move without substantial costs to more profitable markets. Although foreign direct investment cannot be quickly liquidated, it can be abandoned (Maxfield 1997). Because foreign lending is necessary in capital-scarce countries to finance domestic investment, a government may be willing to cater to the interests of international banks. International financial integration and balance-of-payment crises can further reinforce the political influence of these banks as the generators of foreign exchange over a national government's intentions (Maxfield and Haggard 1996, Maxfield 1997, Stallings 1992). Domestic groups that rely on foreign capital are also

[71] Foreign banks are banks in which the majority of shares are owned by foreign firms or in which a foreign firm is the first shareholder and the rest of the shares are dispersed among several shareholders.

[72] Scholars find that foreign banks tend to have lower interest margins and higher profitability than domestic banks in developing countries, while the opposite is true for developed countries. For a review of the empirical literature on foreign banks, see Detragiache et al. (2006), Goldberg (2004).

likely to modify their preferences and create coalitions to promote policies favorable to foreign investors (Evans 1979).[73]

Interests and Behavior of Banks

Financiers—domestic and foreign—have the potential to influence the choice and sustainability of exchange rate regime directly through the pursuit of their interests and their behavior in the exchange rate area, but also indirectly through other areas that involve their central concern. In addition to exchange rate policy, the principal areas of concern for financiers include monetary policy and financial regulation, and particularly restrictions on foreign bank entry.

A specific empirical problem related to research into interest groups is how to identify their preferences and strategies. We can generate a picture of the economic interests of financial interests on the basis of deductive logic from existing economic theories. We can also visualize context-specific strategies on the basis of existing empirical research and field interviews. In this study, economic interests are assumed to be exogenous and are not expected to change, as long as the actors behave rationally and seek to maximize profits. What we can observe are the policy preferences that different types of banks have, or the varying strategies by which they seek to achieve their goals. Financier interests do not automatically translate into political action or influence. As argued above, the ownership structure and institutional characteristics of the financial system intervene.[74]

[73] Nonetheless, if host governments grant foreign banks special privileges that allow them to establish a monopolistic position on host markets, their entry will not bring positive results (Mishkin 2006: 47).

[74] The discussion on the differences between economic interests, i.e., preferences over outcomes and policy preferences, i.e., preferences over actions is based on Crystal (2003).

Monetary Policy

According to the traditional argument, to protect the real value of their portfolios, the most universal preferences of banks are low inflation and stable monetary policy (Henning 1994, Maxfield 1997, Havrilesky 1990, Kirshner 2007, Posen 1993, Goodman 1992).[75] Banks as creditors favor price stability because inflation decreases the real value of their liabilities. They are particularly sensitive to change in the spread of interest rates, which is usually associated with high inflation.

I argue that in certain institutional contexts and situations, banks might not favor low inflation rates or policies aimed at low inflation. Banks may fear hawkish disinflationary policies of the central bank such as a radical increase in real interest rates to sustain a fixed exchange rate in the face of inflationary pressures. Interest rate hikes not only reduce bank profits but may also make the recovery of disbursed loans more difficult, thereby increasing the probability of bank insolvency (Cukierman 1991). Financiers may act as "rent-seekers" and support monetary policies aimed at "sub-optimal" levels of inflation (Kirshner 1998: 75). An increase in nominal interest rates as a result of higher inflation may only mask larger interest rate spreads applied by banks. Banks may consider anti-inflationary policies undesirable, particularly if they have benefited from conditions of high inflation (Tompson 1997, Treisman 1998). As a result of restrictive monetary policy, central bank credits become more expensive, higher reserve requirements squeeze banks' liquidity, and access to budgetary funds is curtailed.

The empirical evidence from EE supports the claim that not all types of finance are inherently inflation-averse. In some post-communist societies, SOBs, nominally privatized banks, and private domestic banks with government ties often acted as a

[75] Kirshner (2007) extends this argument into the realm of national security. For him, the preference of banks for low inflation also determines their preferences for cautious national security strategies because war almost always results in inflation and erosion of monetary discipline.

"pro-inflation lobby" because they were the main beneficiaries of inflation by paying negative interest rates on deposits and earning a float (a form of inflation tax; Treisman 1998, Johnson 2000).[76] Inflation also eased the burden of nonperforming assets on bank portfolios. Incumbent banks in EE opposed fixed exchange rate regimes used to bring inflationary expectations down, mostly in the framework of exchange rate–based stabilization programs.[77]

The expansive credit policies of incumbent banks also make it difficult to achieve price stability. Lacking concern about the inflationary consequences of their policy strategies, incumbent banks with governmental ties grant risky "soft" loans to connected enterprises. Negative real interest rates due to high inflation result in low levels of financial intermediation, capital flights, low savings, and often a cyclical pattern of macroeconomic fluctuation. Such lax industrial lending practices of incumbent banks often lead to inflationary pressures and banking problems.

To stabilize inflationary expectations, a government can grant independence to a central bank, with the legal stipulation of providing price stability. Independent central banks are less prone to political business cycles associated with expansionary policies to lower unemployment and interest rates before elections.[78] Central banks with a higher degree of independence from government will be also less prone to providing below-market discount loans to connected enterprises. Posen (1993) and

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[76] According to the estimations of Easterly and Vieira da Cunha (quoted in Treisman 1998: 9), the Russian banking sector received 8 percent of the country's GDP in 1992 through the inflation tax.

[77] Flexible regimes also may be used to fight inflation, but in conjunction with other anti-inflationary strategies, including monetary or inflation targets. Monetary targeting focuses on controlling the growth rate of domestic money-supply aggregates. Inflation targeting is based on a pre-announced inflation target and on policy responses to deviations between inflation forecasts and the target.

[78] Empirical studies show, however, that legal independence of the central bank is correlated with low inflation (and high growth) in developed, but not in developing countries (Maxfield 1997). For transition economies, this relationship holds only at high and sustained levels of liberalization (Cukierman, Miller and Neyapti 2002). For a review of the literature on central bank independence, see Eijffinger and De Haan (1996).

Goodman (1992) argue that a financial sector's strength can predict not only inflation but also the legal independence of the central bank. For them, the financial sector, which is usually highly inflation-averse, should constitute the core constituency supporting central bank independence.[79]

In light of the previous discussion, it is plausible to assume that not all groups of financiers have incentives to support central bank independence. Banks that do not favor price stability also do not favor central bank independence. Similarly, we can expect incumbent industrialists to be hostile to an independent central bank, fearing that they might lose privileged access to finance. In addition, central banks themselves can support the banking sector and thus generate significant inflationary pressures.

Foreign banks in transition and developing countries may be better able to resist the moral suasion of host governments to lend to politically favored constituents or loss-making sectors of the economy, or to purchase government-issued bonds (Kroszner 1998: 25). Foreign financiers hold standard preferences for monetary stability and low inflation. To this end, international banks have more conservative lending policies. The greater presence of foreign banks may thus be a stabilizing force in host financial markets because the banks tend to pay greater attention to loan quality and to diversification of exposure (Crystal et al. 2001). In countries with weak central banks that make it difficult to commit to low inflation, or for governments with low credibility in international financial markets, foreign bank ownership can serve as a signal of commitment and as a transparency device (Gros 2003). Foreign bank entry promises the beneficial side effect of disciplining a host government's monetary (and

[79] Adolph (2004) argues that central bank behavior depends also on the agents who run it. Thus, central banks whose members are in the financial sector, i.e., "conservative," are more inflation averse than those banks whose members are career bureaucrats.

fiscal) policies, making a fixed regime more sustainable and resistant to speculative attacks (Obstfeld 1998, Goldberg 2004: 9).

Because foreign banks value price stability, they should be the primary constituency of independent central banks. In fact, developing country governments often grant independence to their central banks in order to signal commitment to low inflation to international investors and creditors (Maxfield 1997).

Financial Regulation

Bank regulatory and supervisory institutions can reduce imprudent borrowing and lending by banks, limit currency mismatches, restrict connected lending, ensure that banks have enough capital, and reduce moral hazards associated with governmental guarantees to provide bailouts to banks.[80] In general, commercial banks, similar to any other private businesses, prefer fewer restrictions on their activities. Nevertheless, domestic incumbent banks tend to benefit the most from *protective* national regulation, in which the government explicitly guarantees loans these banks make or provides a guarantee to borrowers or to banks themselves when they encounter financial difficulties. The government provides the "safety net" to banks through the lender-of-last-resort facility, deposit insurance, and the "too-big-to-fail" policy (Mishkin 2006).

Governments adopt these protective policies usually because they want to protect the banking system and depositors against a systemic banking crisis, but sometimes they do so under pressure from the powerful bankers they supervise (Stern and Feldman 2004). This governmental safety net can create moral hazards by

[80] Regulatory and supervisory policies that influence "sound" banking include restrictions on bank activities and on the mixing of banking and commerce, regulations on domestic and foreign bank entry, on capital adequacy, a deposit insurance system, loan-classification stringency, and troubled-bank resolution actions. For a comprehensive analysis and a database of bank regulation and supervision, see Barth, Caprio and Levine (2002a, 2002b).

providing insolvent banks incentives to "gamble on resurrection."[81] Banks grant excessively risky loans while expecting that their future losses will be borne by taxpayers (Williamson and Mahar 1998: 3). The protection of large SOBs also encourages the depositors to put their money in these banks, thereby making it easier for the government to direct resources to favored industries and enterprises (Stern and Feldman 2004). The governments can induce additional moral-hazard behavior by pressuring the central banks to use foreign exchange reserves to bail out domestic banks with liquidity problems resulting from imprudent lending policies. The combination of protective regulation and moral hazard behavior of SOBs results in a situation in which these banks burden governments with large contingent liabilities arising from guarantees that some of these banks (and large state-owned industries, their clients) are "too-big (or too-political)-to fail" (Caprio et al. 2004: 2).

Financial deregulation may lead to opposition from incumbent banks. Financial liberalization eliminates interest rates and other price controls, together with less administrative direction of credit by governments, and thus leads to a reduction of the implicit taxation of banks. But it also exposes the bad loan portfolios of banks, the outcome of the previous bad credit allocation to borrowing enterprises no longer able to service debts because government subsidies or guarantees on loans were discontinued. Moreover, liberalization increases the short-term volatility in nominal interest rates and asset prices that changes the distribution of credit and reduces rents of the state-owned sector and favored borrowers (Kaminsky and Reinhart 1999, Demirguc-Kunt and Detragiache 1997).

[81] Eichengreen and Hausmann (1999: 6) characterize the "moral hazard" problem as a situation with the following characteristics: 1) banks are leveraged and have limited liability, 2) markets have asymmetric information about the risks banks take, and 3) banks are rescued with some probability when they have financial problems.

Incumbent domestic banks may particularly benefit from restrictions on bank entry because they fear increased exposure to competition, mainly from international banks. Incumbent banks are expected to favor regulation preventing foreign entry of banks into the financial sector, as newcomers will compete away their rents. They would also oppose any prudential regulation and supervision of their activities that would limit the expansion of their balance sheets beyond their capital, prevent short-term borrowing, and curb their profit-making opportunities.

Although the interests of domestic banks with regard to regulatory restrictions on capital flows are not clear-cut, capital openness facilitates access of banks to funds for lending (Horowitz 2005: 116, Kaminsky and Schmukler 2003: 22).[82] They can gain from intermediation of foreign purchases of domestic securities and from arbitrage opportunities in international financial markets (Haggard and Maxfield 1996: 39). Capital account liberalization, combined with the moral hazards associated with governmental guarantees to provide bailouts, may, however, encourage banks to discount the risk of default and to engage in speculative short-term financial transactions (Montinola 2003). With limited liability and governmental guarantees if their capital erodes, banks would bear little risk of liberalization of capital and would favor it.[83] It is plausible that domestic banks, searching for new profit-making opportunities and speculator transactions on international markets, influenced the deregulation of capital flows in EE to varying degrees.[84]

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[82] Alternatively, domestic banks may oppose the removal of capital controls because capital can flow away to more attractive destinations, limiting sources of bank funds; and capital inflows may erode their monopoly as suppliers of funds to industries (Horowitz 2005).

[83] The variation in financial liberalization outcomes has been attributed to partisanship (Quinn and Inclán 1997), central bank independence (Epstein and Schorr 1992), and crises (Haggard and Maxfield 1996). More recent studies suggest the role of diffusion in financial liberalization (Simmons and Elkins 2004, Brune and Guisinger 2006).

[84] For example, Russia, Ukraine, and Armenia as well as the Czech Republic have rapidly and fully liberalized their capital accounts despite severe macroeconomic instabilities.

The appointment of a conservative and independent regulator/supervisor, which will be less likely to pursue bank bailouts, can help reduce moral hazards created by the governmental safety net (Stern and Feldman 2004). In most countries, the regulatory authority is vested in the central bank, although bank regulation can be also assigned to a separate agency.[85] Independent central banks are less likely to act as lenders of last resort to the banking system during a banking crisis or to accommodate fiscal expansion to bail out banks (Rosas 2006: 179). Therefore, we can expect that incumbent banks would want to capture a central bank (or other bank regulator), ensuring them rents from lax banking supervision and weak prudential regulation.

Foreign investors should favor the financial liberalization of both entry into the banking sector and capital flows because it allows them to expand into new markets, increases their investment opportunities and profits, and gives them a stronger political voice.[86] Foreign banks as equity investors are sensitive to regulation of the capital account because it can also affect their repatriation and liquidation options (Maxfield 1997: 40). Foreign investors are not passive bystanders in the financial regulatory reforms in the countries they invest in; rather, they examine dangers and problems related to their investment and push for a regulatory framework that protects their interests, including regulation that lowers the risk of banking and financial crises (Hewko 2002/2003). Large foreign banks tend to favor strict regulation when investing in less developed economies because they risk their international reputation and face larger default costs (Mian 2003). In addition, the likelihood of bailing out the

[85] In EE, Hungary and Bosnia and Hercegovina have separate agencies for the prudential supervision of banks.

[86] Cohen (1989) noticed that while large banks benefit from cross-border operations and financial integration, small banks tend to prefer national regulation. Similarly, Gruner and Hefeker (1996) argued that large European banks pushed for a full financial integration of banking regulation within the European single market because it promised greater cross-border bank cooperation.

uninsured depositors and creditors of foreign banks by host governments is lower than that for domestic banks. It is politically more difficult to sell to the public the need to save a foreign bank from domestic resources (Gross 2003).

Although foreign banks have more funds to cover potential loan losses, a low probability of being bailed out discourages foreign banks from risk-taking behavior (Mishkin 2006: 151). In addition, large international banks have access to international sources of capital and can build investor confidence. In the face of financial turmoil, these banks can be a stabilizing factor and provide a safety net for panicking depositors (Stallings with Studart 2006).[87]

Exchange Rates

Domestic incumbent banks are likely to favor the monetary autonomy associated with a flexible regime that gives the government flexibility to define interest rates and expand the money supply. Under a flexible regime, exchange rate adjustments to support domestic enterprises are less visible to the public and, consequently, are less politically costly than devaluation under a fixed regime (Collins 1996).

Furthermore, fixed exchange rates, in combination with liberalized capital flows, can lead to frequent changes in foreign demand for domestic currency and thus to high volatility in interest rates. In order to generate profits, banks usually pass these changes in interest rates on to their customers through credit channels, thus making it more difficult for banks to establish long-term relationships with their borrowers. Therefore, domestic banks, which have close multiple ties with borrowing enterprises, may favor more flexible exchange rates (Hall 2005).

[87] Still, the presence of foreign banks can increase the risk of contagion through common lender effects. The risk of contagion can be reduced if foreign banks have a subsidiary presence at host markets and not portfolio capital alone (Goldberg 2004: 18).

Under some circumstances, incumbent banks may have vested interests in fixed regimes but behave in ways that render these regimes unsustainable. In countries that have adopted fixed regimes, a *double* moral hazard situation emerges: domestic banks take un-hedged dollar-denominated loans from abroad and then issue domestic currency loans to certain enterprises. Banks have little incentive to hedge their foreign exposures because the government offers insurance against the risk of exchange rates of both domestic borrowers and foreign investors (Eichengreen and Hausmann 1999). In the presence of governmental guarantees, it is profitable for banks to increase their foreign exposure, for it will bring them additional returns in the absence of currency devaluation. Banks that accumulate dollar-denominated debt end up with varying degrees of currency (or maturity) mismatches on their balance sheets.[88] Faced with currency mismatches, banks will favor exchange rate stability and thus the maintenance of a fixed regime, for the sharp nominal devaluation of domestic currency may have a negative impact on their solvency.

However, when a government tries to defend the currency peg by selling its foreign exchange reserves and by increasing interest rates, banks faced with the increased costs of funding are forced to call their loans, thus imposing severe strains on enterprises. This defense can precipitate defaults on short-term domestic debts and lead to banking crises (Eichengreen and Hausmann 1999). Balance-sheet banking problems can lead to balance-of-payment crises. In accordance with the "third generation" models of currency crises, the collapse of a fixed exchange rate regime then occurs as the result of imperfect information and moral hazards due to governmental guarantees to banks without an adequate system of banking regulation

[88] A "currency mismatch" occurs when projects that generate domestic currency are financed with foreign currency. A "maturity mismatch" occurs when long-term projects are financed with short-term loans (Eichengreen and Haussmann 1999: 3).

and supervision (Krugman 1998, Chang and Velasco 1998, Corsetti, Pesenti, and Roubini 1998). These models are also called "twin crises" models because currency and banking crises often occur together.[89] The severe banking crises that forced central banks to print money to bail out failing banks, contributed to currency-debt crises and collapses of exchange rate regimes. These banking crises present a dilemma for governments that bail out failing banks and save the banking system on one hand, and restrict monetary policy of high interest rates to defend exchange rate regime, on the other.[90]

Foreign banks focus on cross-border transactions and are thus more sensitive than domestic banks to changes in aggregate foreign currency deposits because volatile exchange rates create uncertainty about international transactions (Mian 2003: 5). Banks engaged in international business have a greater capacity to protect themselves and to profit from short-term exchange rate fluctuations (McNamara 1998: 37–38, Oatley 1997: 17). But hedging is costly and more difficult beyond one-year periods because of limited forward markets (Hefeker 1997: 61).[91] Hedging is particularly difficult in underdeveloped financial systems and for small countries' currencies (Cooper 1999: 111). Even the most sophisticated hedges are no substitute for stable exchange rates (Dumas 1994), so international banks, as *foreign direct investors*, prefer to invest in countries with fixed regimes. They would rather bear the

[89] While most often a banking crisis predates a currency crisis, the causal link is not unidirectional (Kaminsky and Reinhart 1999).

[90] Copelovich and Singer (2007) advance the argument that central banks responsible for both monetary policy and bank regulation, and confronted by two potentially conflicting goals—fighting inflation and maintaining financial stability—are more sensitive to bank stability. Therefore, they will less likely to engage in aggressive interest rate adjustments in the face of inflationary pressures than when bank regulation is assigned to a separate agency. For the examination of the determinants of government responses to banking crises, see Keefer (2006) and Rosas (2006).

[91] The innovative credit markets have not yet invented hedges for credit risk, considered to be the greatest banking risk. Natural hedges, achieved by negative correlations within the bank portfolio, are hard to find as credit exposures more often exhibit some degree of correlation with one another.

risk of sharp devaluations than the risk arising from a non-credible monetary policy and high exchange rate volatility (Papaioannou 2005).[92] They tend to suffer less from the devaluation of host-country currency because they lend primarily to exporters and large foreign corporations, who usually benefit from a lower currency value (Tschoegl 2003).

Foreign banks, as *portfolio investors*, are also interested in price and financial stability and in risk reduction (Maxfield 1997: 42–45). Foreign banks lending to developing and transition countries should be particularly favorable to fixed regimes in order to decrease the risk of non-repayment and increase the risk-adjusted rate of return (Shambaugh 2004: 284).[93] Governments in less developed countries experiencing a shortage of capital may have incentives to adopt a fixed regime, in part to attract foreign investors.

In sum, large international banks earn an important portion of their profits from cross-border operations; therefore, the banks desire a high level of financial integration to increase the volume of banking transactions. Because of economies of scale, financial integration enables these banks to provide cross-border financial services more cheaply and to gain a larger market share (Hefeker 1997: 6). Because of their orientation toward international finance, international banks tend to favor stable exchange rates to promote overseas investment and to reduce currency risks. A credible fixed regime, combined with sufficiently high levels of foreign exchange reserves to discourage currency speculators, decreases risk and increases profit

[92] The exchange rate preferences of foreign investors in the real sector vary depending on their investment motivations. If foreign investors seek export platforms in host countries, then their exchange rate preferences will converge with those of the export-oriented sectors, and they will prefer flexible regimes. On the other hand, investors seeking export platforms for specialized manufactured goods with limited "pass through" who are not affected by exchange rate volatility will prefer fixed regimes. See Shambaugh (2004).

[93] Shambaugh (2004: 286) argues that host governments relying on foreign portfolio investors may prefer a flexible regime to reduce the risk of sudden capital flight.

opportunities for banks. International banks are thus supporters of the monetary integration of fixed exchange rates.[94] International financiers are also likely to favor an independent central bank to the extent that it can prevent excessive exchange rate volatility. Table 1 summarizes the expected interests and behavior of state-owned and foreign banks in exchange rate, and in monetary and regulatory policies.

Table 2.1: Expected Interests and Behavior of Banks

INSTITUTION/ POLICY AREA	*STATE-OWNED BANKS*	*FOREIGN BANKS*
MONETARY POLICY	High inflation	Price stability
	Expansive credit policies and connected lending	Conservative lending policies
	Subordinate central banks	Independent central banks
REGULATION	Protective regulation and restrictions on the right of bank establishment/entry	Deregulation of capital flows and bank entry
	Deregulation of capital flows—speculation on international markets	Strict regulatory and risk-management practices
	Government safety net: bailouts, too-big-to-fail, and deposit insurance	"Hard-budget" constraints in lending
	"Soft-budget" constraints in lending.	
EXCHANGE RATES	Monetary autonomy and flexible regimes	Monetary convergence and fixed regimes
	Fixed, but unsustainable regimes if faced with currency mismatches	International monetary integration

[94] Hefeker (1997) observes that the major European banks were strong lobbyists for the European monetary union.

Conclusion

This chapter has outlined the theory that politicians' decisions to adopt and sustain a fixed exchange rate regime should be an increasing function of the financial institutional structures dominated by outsider financiers and stable monetary and regulatory institutions. My argument is the second cousin to arguments linking macroeconomic policies to the relative capability of the financial sector to influence government actors. Still, I go beyond that and show how and why government responsiveness varies with bank ownership structure. This study tells a story about forces shaping exchange rate policy making, linking financial ownership and institutional structures to the relative capacity of different financial actors to influence government actions. The argument is also broadly consistent with other arguments stressing the structural power of foreign capital in influencing government actions. The impact of the conditions set by international financial institutions to explain their exchange rate policy choices is secondary to domestic conditions in transition economies in which their external monetary policy choices reflect primarily the finance logic of domestic distribution and institution building. While arguments stressing economic institutions (i.e., property rights, and monetary and regulatory institutions) and regime type are consistent with the argument presented in this study, arguments stressing how various political institutions, such as political parties alone, have little relevance for explaining how exchange rate regimes evolve in the post-communist EE.

CHAPTER 3

THE VARIETY OF FINANCIAL SYSTEMS IN EASTERN EUROPE

"…free financial markets are the elixir that fuels the process of creative destruction, continuously rejuvenating the capitalist system. As such, they are also the primary target of the powerful interests that fear change."
Rajan and Zingales[95]

In the preceding chapter, I developed just one dimension of my finance-based theory of exchange rate regime choice by exploring the sources of the political influence of banks on government politicians. I also identified the interests and strategies of SOBs, private domestic banks, and foreign banks regarding exchange rate and monetary and regulatory policies. The second dimension of the theory suggests that government responsiveness to the demands of various types of banks is a function of the national financial system in place at the time. In this chapter I go one step back and examine what determines the development of a national financial system in EE. The principal explanatory factor presented is financial openness to foreign entry in the banking sector through privatization.

The financial system—"the brain of the economy"—coordinates the channeling of funds from households and enterprises that have surplus funds to those that have a shortage of funds and allocates savings to the best investment opportunities (Mishkin 2006: 25).[96] A growing body of literature demonstrates a strong positive link between the functioning of the financial system and long-run economic growth (Levine 2004).[97] The experience of the post-communist countries of EE represents a

[95] Rajan and Zingales (2003b: 25).

[96] Financial systems provide five broad functions: 1) evaluating projects and allocating capital, 2) exerting corporate control, 3) facilitating risk management, 4) mobilizing and pooling savings, and 5) facilitating exchange (Levine 2004).

[97] Some scholars, however, disagree and insist that instead of causing growth, financial institutions only respond to demands from the enterprise sector. A notable example of this view is Joan Robinson's (1952: 86) claim that "where enterprise leads finance follows."

unique opportunity to shed new light on issues of financial development.

The development of the financial system in post-communist EE provides a natural experiment in that most EE countries began the transition with a *monobank* system, in which both money supply and credit allocation functions were located within a single institution. The transition from a command economy, where almost all property was state-owned, to a market economy with individual property rights was a quasi-experiment in which a completely new set of institutions were created over a short period of time. Facing similar financial liberalization pressures (and Europeanization for a subset of countries), EE countries pursued a remarkable diversity of financial development policies intended to create market-oriented financial systems. These different financial reform strategies led to a variety of financial systems that were consequential for their monetary and exchange rate policies. If we define the exchange rate policies of EE states as the result of diverse financial institutional structures, we explain one puzzle but reveal a new one: What are the sources of this diversity of financial development in the EE region?[98]

I argue that the variation in the timing and the mode of divestiture of state assets in banks (and industries) and the opening to foreign bank entry have had major consequences for the variation in financial systems in EE. Varying financial reform strategies in the region have yielded two principal types of financial systems: clientelistic and open. These systems can be distinguished according to the nature of the structure of bank ownership, which can take one of three possible forms: state, private domestic, or foreign. Institutional governance; that is, monetary and regulatory institutions and the accompanying features of the financial architecture, then depends crucially on the ownership structure.

[98] In this respect, the approach of sequenced explanations adopted by Katzenstein (1985) is similar to that employed in this dissertation.

Financial reforms are difficult to implement because of opposition from entrenched parties. The most important source of such opposition is usually SOBs, as well as their clients, state-owned enterprises. If a government defers the hard choice to privatize government banks (and industries) or uses insider privatization schemes that restrict foreign bank entry, a *clientelistic* financial system develops. The oligopolistic bank ownership structure remains dominated by incumbent, mainly government, banks, so the financial system remains repressed, which allows the government to impose discretionary policies. The regulatory and monetary institutions manage bank licensing, imprudent bank borrowing and lending, and the moral hazard associated with governmental guarantees to provide bailouts to domestic banks also remain weak. Weak corporate governance allows rent-seeking networks of incumbent financiers and industrialists whoa re connected through lending and ownership to preserve political channels to control the governments. Because of their privileged access to government politicians, incumbents have the power to obtain their preferred economic policies. Incumbent influence is more likely to result in excessive moral hazard behavior by banks, high volumes of nonperforming loans, poor protection of property rights, costly bank bailouts, and forced changes in exchange rate regimes after systemic banking and financial crises.

In contrast, if a country allows foreigners to assume the role of strategic investors in domestic SOBs through transparent privatization, an *open* financial system develops. The entry of foreign banks weakens discretionary forms of state intervention and the political influence that was established during communism of clientelistic networks among banks, industries, and the state. Openness to international banks—agents of globalization—simultaneously fosters competition, under which governments have incentives to build strong regulatory institutions and credible central banks. This openness also creates a new set of domestic private banks with the

potential to demand these institutions.[99] Foreign financiers have vested interests in ensuring strong institutions that will protect their property rights and stable profits. The government is also motivated to improve the quality of institutions that enable it to regulate foreign financiers and extract revenues from them. This institutional setting allows governments to harden budget constraints and pursue sustainable financial and exchange rate policies aimed at economic stabilization and growth.

Within each financial system, I further identify two subtypes depending on the status of the central bank.[100] The central bank can have independent or subordinate status in both types of financial systems in the economy.[101] I thus identify four ideal types of financial institutional arrangements that I call *capture, collusion, consensus*, and *competition.*[102] When a small network of incumbent banks and enterprise managers is able to dominate the government and the central bank through personal and ownership ties, the likely outcome is capture, which leads to discretionary monetary policies and unsustainable exchange-rate regimes. Collusion is the state of affairs in which incumbent banking ties to industry are close, either through management or ownership, and in which there is also a fusion of interests among banks, industries, and the government, but the central bank is autonomous. The likely outcome is an incoherent and unsustainable monetary-fiscal policy mix. Consensus is the type of system in which ties between (domestic and foreign) banks and industries are market-based but the policy interests of the ministry of finance (and other

[99] In EE, it was not until foreign banks were allowed to acquire strategic stakes in the domestic banking sectors that private ownership took a firm hold (Berglof and Bolton 2002: 85).

[100] The four-fold typology presented below is based on the empirical data from EE.

[101] In this chapter, I do not systematically explore the reasons for this variation in central-bank independence. However, I carefully trace the relationship among central banks, commercial banks (domestic and foreign), and industries in my case studies.

[102] I am indebted to Anna Grzymala-Busse for her excellent insights on business-government relationships in various EE countries that significantly influenced my typology.

economic ministries involved in exchange rate policy-making) overlap with those of the central bank. The economic policy pattern is likely to be a stable currency, but exchange rate policies are adjusted to the needs of economic sectors. Finally, competition is the state of affairs in which ties between (mostly foreign) banks, industries, and the government are weak, and the central bank is autonomous. The resulting economic policy in this case is likely to favor exchange rate fixity. Figure 3.1 displays the key dimensions and characteristics of the different financial systems.

Departing from the standard view on central bank independence, I argue that granting legal independence to a central bank does not necessarily lead to good economic outcomes (as the Czech case illustrated in chapter 7 demonstrates). The importance of an independent central bank is contingent on the bank ownership structure. In other words, the distinction between incumbent versus foreign-dominated banking structures conditions the importance of central bank independence and how it functions.[103]

In section 1 of the next part of this chapter, I briefly consider the strengths and weaknesses of existing explanations of financial system variation. In section 2, I explore various privatization strategies and present the logic of my argument on financial system development. In section 3, I empirically examine the differences in financial development using a sample of 25 EE countries.

[103] I am grateful to Christopher Way for this thoughtful remark.

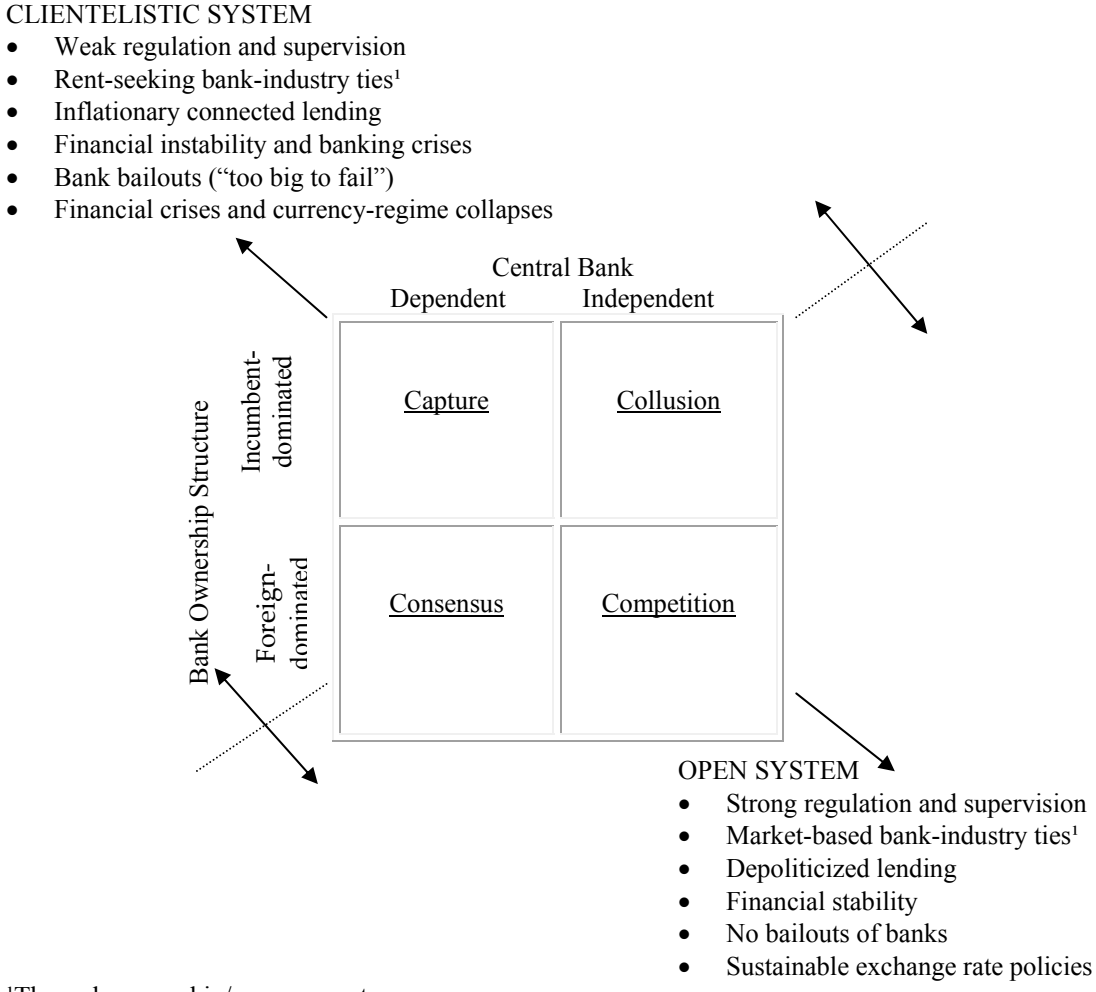

Figure 3.1: Key dimensions and characteristics of financial systems

Related Literature

My study touches on many of the themes of the financial development and growth literature. Alexander Gerschenkron (1962) provided the most ambitious explanation of a national diversity of financial systems, emphasizing access to capital. Two types of financial systems were identified based on these criteria: *bank-based* and *market-based* financial systems. In market-based systems, financial markets directly channel capital from savers to investors (direct finance). In bank-based systems,

financial intermediaries, such as banks, provide loans to enterprises for financing their investments (indirect finance). Gerschenkron linked the timing of industrialization to the organization of the financial system while focusing on the relative degrees of market, bank, and state intermediation in providing long-term capital: whereas the British industrialization was market-financed, French and German industrialization was financed by banks.[104] In extremely backward countries, such as Russia, it was the government that generally fulfilled the function of the bank and encouraged economic growth (Gerschenkron 1962: 22).

Zysman (1983) applied Gerschenkron's insight to the study of industrial policy in the postwar period and identified France (instead of Russia) as the model of a state-led banking system. Rather than emphasizing the extent of a country's economic backwardness, Verdier (2001, 2004) stressed the degree of state centralization in explaining why some countries (Britain and France) but not others (Germany) developed corporate securities markets.[105] Hall (2005) showed that in developing countries, the dominant type of finance systems is the private-savings system, in which domestic investment is financed mostly by the private savings of investors.

These explanations and typologies of financial systems focus predominantly on developed countries and do not seem very helpful for examining EE. It has been argued that EE societies share many features of late industrializers; their private

[104] Industrialization in France was financed by investment banks, whereas in Germany it was financed by universal banks.

[105] Economists and policymakers have long debated the relative benefits of bank-based versus market-based financial systems, mostly comparing four countries—Germany and Japan versus the United States and the United Kingdom. The results of Levine's (2002) broad cross-country examination show that although overall financial development is strongly correlated with economic growth, there is no support for the superiority of either the bank-based or the market-based view. Although banks may perform better than "atomistic" markets at identifying innovative projects and enterprises, effectively monitoring managers and financial industrial expansion; banks may also acquire powerful influence over and extract rents from enterprises. Bank managers may collude with enterprises with which they have long-term, multidimensional ties against other creditors and be reluctant to bankrupt such enterprises (Levine 2004: 26-33).

enterprises exhibit a high reliance on lending from commercial banks for shortages of capital and credit (Roderick 2002).[106] Most empirical analyses of financial development in EE thus concluded that the financial system best suited to developmental needs, and the one that has actually emerged in all EE countries, is closer to the German system than the American one (Gross and Steinherr 2004, Bolton and Berglof 2002).[107] This difference exists despite the rhetoric of EE governments to follow IMF prescriptions and to model their economies on Anglo-American capitalism.

Post-communist financial systems are strongly dominated by banks, and ownership structures in individual firms and banks are highly concentrated. Capital markets are relatively underdeveloped, volatile, and illiquid, with trade concentrated in a small number of enterprises. Some EE countries, including Albania, Belarus, Bosnia-Herzegovina, Georgia, Tajikistan, and Turkmenistan have never established stock markets (Berglof and Bolton 2002). Only Russia has occasionally been depicted as an exception in EE as it moves in the direction of a market-based system because of several factors: the "securities friendly" nature of its enterprise privatization through the distribution of vouchers, decentralization of its banking system, and, finally, the periods of high inflation that undermined bank intermediation (Popov 1999).

Nevertheless, the banking systems in EE countries seem to be hybrids of different systems rather than pure versions of the German model of cross-shareholding

[106] Historically, late industrializing societies used commercial banks or state banks to achieve strategic national objectives (Gershenkron 1962).

[107] In the 1990s, bank-related scandals in Germany raised doubts about the benefits of the bank-based system, with the primary criticism revolving around anti-competitive practices, biases towards heavy industry, and banking system instability. Critics denounced relationship-based banking because it gave banks disproportionate power over enterprises and allowed them to exploit their positions by imposing collusive agreements and mergers. The outcome was a concentration of financial services accompanied by the increased market power of a few large banks and high finance costs. German and French financial systems have recently undergone deep transformation through liberalization and large-scale privatization, which lead to a gradual *rapprochement* to a market-based model of finance (Fohlin 2007).

or the securities-based system. For example, the Czech banking system in the 1990s was characterized as a hybrid of the French "price-administered" and the German "oligopolistic" credit systems (Desai 1995). Rostowski (1995) argued that it is unlikely that transition economies will develop German-style universal banks because their SOBs, ill-equipped to allocate and manage long-term credit, are likely to fail to exercise strict financial control over borrowers.

Given that financial systems in most EE economies are underdeveloped, the approaches that would be more helpful in studying these systems would be those that point to the complementarities between markets and banks and that focus on the sources of cross-national variance in financial development across nations.[108] One strand of this literature stresses the importance of differences in national legal systems, showing that English common law systems have stronger investor-protection enforcement and thus more developed financial systems than civil law systems (La Porta et al. 1997 and 1998).[109] Yet, despite inheriting the same set of civil law systems, EE countries have not performed equally well in developing their financial systems.[110] The more recent political economy strand recognizes the relationship between various political factors and financial systems development (Haggard et al. 1993, Kroszner 1998, Haber et al. 2003, Pagano and Volpin 2005, Rajan and Zingales 2003a, 2003b, Fries 2005, Keefer 2006, Stallings with Studart 2006).[111]

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[108] A developed financial system exhibits the following characteristics: 1) protection of property rights, 2) an accounting and disclosure system that promotes transparency, 3) a legal system that enforces market contracts, and 4) a regulatory infrastructure that protects consumers, promotes competition, and controls excessive risk-taking (Rajan and Zingales 2003a: 18).

[109] Researchers working within this tradition have related financial development to property rights, enforcement of financial contracts, and investor protection.

[110] Only Russia has had a brief, but unsuccessful, experiment in a common-law approach to corporate law (Berglof and Bolton 2002: 90).

[111] See King and Levine (1993), Levine (1997), and Levine and Zervos (1998) for the recent landmark studies on financial development and growth, and Levine (2004) for a recent review of this literature.

My explanation of the variation in EE financial systems is most closely related to the interest group theory of financial development developed by Rajan and Zingales (2003a, 2003b). Its foundations are worth some elaboration. According to this theory, when financial markets are underdeveloped, incumbent interest groups—financiers and industrialists—reap all the benefits of new business opportunities. These groups are the only ones with access to capital, through internal cash flows or relationship-based finance, and they will use their political power to oppose financial development because it introduces competition and erodes their positional rents and relationships.[112] However, the greater the openness of a country to trade and capital flows, the weaker the ability of incumbents to impede financial development. When a country is open to foreign trade, incumbent industries cannot charge monopoly prices. Similarly, when a country is open to global financial flows, enterprises are not limited to financing supplied by incumbents. Thus, the variation in the extent of financial development among countries and over time is a function of the variation in both trade barriers and capital openness. Along the same lines, Fries (2005) argued that banking reforms in EE advanced when vested interests from the previous regime in the industrial sector weakened in the face of trade and financial openness enhancing competition.[113]

The current study can be viewed as an extension of this approach by showing that when a country is open to foreign competition in its financial sector and allows privatization by foreign investors, the political influence of incumbent financiers and industrialists is reduced. I thus argue that variation in financial structures is a function

[112] The literature examining the sources of interest-group influence on governments includes information asymmetries (Helpman and Grossman 1996), institutions (Persson and Tabellini 2000), and collective-action problems (Olson 1965).

[113] Studies also have identified determinants of financial development that are *exogenous* to contemporary political processes, such as the nature of European colonization (Acemoglu and Johnson 2003), religion, and social capital (Guiso, Sapienza and Zingales 2004).

of variation in the barriers to foreign investments in the banking sector.

Explanation of the Variety of Financial Systems in EE

Overall Background

Before the collapse of communism, EE countries had financial systems based on a "monobank" that performed all banking functions: issuing money, acting as the state treasury, and existing as the only source of credit for the economy (Lavigne 1999: 186–189). Under a command economy, governments used SOBs to direct credit to state enterprises for production and investments for attaining output targets that conformed to economic plans. Socialist financial systems consisted of government banks specialized by economic sector or foreign trade (like investment, agricultural, trade-finance banks), a national bank, and savings banks.

Financial markets in socialist countries were "financially repressed." In such a system, it was the government that determined who gives or receives credit, and at what price (Williamson and Mahar 1998: 2, McKinnon 1991).[114] Financial repression permitted EE governments to impose policies, regulations, and informal controls that included selective and sectoral credit schemes, high reserve requirements, interest rate ceilings, and controls on foreign exchange that inhibited the standard operation of banks (Denizer et al. 2006). The costs of financial repression were usually borne by depositors who received low or negative interest on their funds and by small enterprises that had limited access to credit (Stallings with Studart 2006: 22–23).

Socialist financial systems were thus simply "accounting control and cash disbursement vehicles" for the state, which also provided deposit and payment

[114] Financial repression has a long history. As early as the Middle Ages in Europe, forward foreign-exchange contracts (bills of exchange) were invented to bypass interest rate controls (Caprio et al. 2001: 4, fn. 1).

services to enterprises and individual savers (Montes-Negret and Muller 1996). Financial systems have developed through several stages since the collapse of communism. The first task of the new post-communist governments was to create a two-tier banking system with a central bank and independent commercial banks.[115] As table 3.1 shows, some countries had already created a two-tier banking system before the collapse of communism. Initially, both the newly created commercial banks and the "specialty" banks with monopolies in their core activities were state owned, including savings banks that were the only banks with extensive branch networks to collect primary deposits (Bonin et al. 2004).

Table 3.1: Introduction of Two-tier Banking System

Country	*Monobank*	*Year*
Yugoslavia	National Bank of Yugoslavia *Narodna Banka Jugoslavije*	1954
Soviet Union	The State Bank of the USSR *Gosbank*	1987
Hungary	National Bank of Hungary *Magyar Nemzeti Bank*	1988
Poland	National Bank of Poland *Narodowy Bank Polski*	1989
Czechoslovakia	The State Bank of Czechoslovakia *Státní Banka Československá*	1990
Bulgaria	Bulgarian National Bank *Blgarska Narodna Banka*	1991

Financial *liberalization* has been one way to reduce government ownership of banks, to eliminate government-imposed restrictions on financial transactions, and to increase competition in the banking industry. Privatization of government banks and liberalization of restrictions on the entry of private and foreign banks into domestic

[115] For a good discussion of the initial bank reforms in transition economies, see *Journal of Comparative Economics* 1997, volume 25, no. 1 and OECD. Proceedings: The New Banking Landscape in Central and Eastern Europe: Country Experience and Policies for the Future. Paris: CCET: 1997.

financial markets are the key components of financial liberalization (Mishkin 2006, Mahar and Williamson 1998).[116] Bank privatization has been the cornerstone of the financial reforms in EE. Privatization has worked alongside interest rate liberalization, the free entry of new banks, and fundamental changes in regulatory and supervisory institutions to transform socialist banking systems into market-oriented banking systems.[117] The objective of privatization and other bank reforms was to create private property, replacing discretionary forms of state intervention and the rent-seeking of SOBs by increasing competition in financial markets.[118] Thus, Shleifer and Vishny (1998: 10–11) articulate the rationale for privatization in transition countries:

> Privatization then offers an enormous political benefit for the creation of institutions supporting private property because it creates the very private owners who then begin lobbying the government … to create market-supporting institutions … [Such] institutions would follow private property rather than the other way around.

[116] Mishkin (2006: 51) identified two components of financial liberalization: internal and external. While *internal* financial liberalization involves lifting regulations that restrict domestic financial institutions from lending their funds at market rates or that set quantitative limits on the allocation of credit, *external* liberalization focuses on capital account liberalization and openness to foreign banks (Mishkin 2006: 51). In the comprehensive *Survey of Financial Liberalization*, Mahar and Williamson (1998) identified six dimensions of financial liberalization: 1) the elimination of credit controls, 2) the deregulation of interest rates, 3) free entry into the banking sector, 4) bank autonomy, i.e., freeing banks from *ad hoc* interference in bank management, 5) private ownership of banks, and 6) liberalization of international capital flows.

[117] For an excellent discussion of financial sector reforms in transition economies, see Berglof and Bolton (2002), and the EBRD Transition Report 1998: *Financial Sector in Transition*.

[118] Privatization was part of the so-called Type II reforms focused on the establishment of a viable commercial banking system and of the appropriate regulatory infrastructures (Hanoušek, Kočenda and Švejnar 2005).

Privatization and the Logic of Financial Development

The privatization of SOBs has proved to have had a crucial role in the development of financial systems.[119] Bank privatizations were sporadic in the 1960s and 1970s in Europe, but the main wave of privatizations occurred in the 1980s and 1990s in over one hundred countries. Privatization in banking has been much slower, however, than in other sectors, despite its promise of significant gains (Megginson and Netter 2001).[120] In spite of numerous privatizations over the past few decades, extensive governmental ownership of banks persists throughout the world. State ownership of banks also varies widely by region. As table 3.2 shows, in 1995, South Asian countries had the highest share of banking sector assets held by government-controlled banks, followed by the Middle-Eastern and EE countries. Megginson's (2005) comprehensive survey of empirical evidence on bank privatization concluded that an increasingly common outcome of large-scale privatization programs in many countries is foreign ownership of banks, which has a positive economic effect but might be problematic politically.

[119] Numerous studies have demonstrated the positive effects of privatization on the size and liquidity of stock markets, the enhancement of securities diversification, investor confidence-building, and so on. See Boutchkova and Megginson (2000) for a survey of the literature on privatization and financial development.

[120] The share of state-owned enterprises of "global GDP" has declined from more than 10 percent in 1979 to less than 6 percent (Megginson and Netter 2001: 380).

Table 3.2: Ownership Structure of Banking Systems around the World, 1970–1995

	1970		1985		1995	
Region	State	*Private*	*State*	*Private*	*State*	*Private*
Developed	37.0	63.0	31.6	68.4	21.8	78.2
Developing	65.6	34.4	2.6	37.4	48.4	51.2
East Asia Pacific	49.1	50.9	5.7	54.3	41.1	58.9
Eastern Europe	90.2	9.8	6.0	4.0	49.9	50.1
Latin America	65.8	34.2	4.8	45.2	40.1	59.9
Middle East	55.4	44.6	5.1	44.9	54.2	45.8
South Asia	94.7	5.3	97.9	2.1	87.5	12.5
Sub-Saharan Africa	40.8	59.2	48.5	51.5	33.6	66.4

Source: Stallings with Studart (2006: 63).

Bank privatization in EE differs significantly from bank sales in other parts of the world: first, they involved a transformation from a socialist system, in which banks played a central coordinating and credit-rationing function, to a market economy in which banks have completely different functions; and second, many banks were sold through voucher privatization (Megginson 2005).[121] Bank privatization is also significantly different from the privatization of industrial enterprises in EE. EE governments privatized SOBs in smaller numbers and later, they privatized state-owned enterprises.[122]

This study advances the argument that timing and the chosen privatization method significantly determines the overall impact of the privatization process on how the financial system functions. SOBs were the largest banks in the financial markets of EE countries, and their privatization to outsiders was important in limiting their

[121] A special issue of the *Journal of Comparative Economics* (1997, 25) is dedicated to banking privatization in EE.

[122] In contrast to the banking sector, the number of privatized companies in transition economies was very large. Djankov and Murrell (2002) reported over 150 thousand large firms in transition economies that faced transformation changes. See Megginson and Netter (2001), Djankov and Murrell (2002), and Hanoušek, Kočenda and Švejnar (2005) for surveys of a large body of literature on enterprise privatization in EE.

power. Governments privatizing SOBs face a common set of problems that include the method of privatization and the policy for the entry of private/foreign capital.

The different privatization methods used include 1) direct sales to a foreign strategic investor, 2) initial public offering on domestic markets, 3) voucher privatization (sometimes known as "mass privatization"), and 4) management-led buyouts, where bank management, employees, and customers are the first to be offered shares for purchase (Megginson and Netter 2001).[123] In contrast to the first two methods, in which the government expects to raise revenues, in voucher privatization, vouchers exchangeable for shares in state banks and enterprises are distributed at deep discounts to the population. This method, the most controversial method of divesting state assets, has been used exclusively in transition economies.[124] Voucher privatization, with significant concessions to insiders, or management-employee buyouts, is considered here as an "insider" privatization method.

Related to the adopted privatization method is a determination of the maximum stake that any single investor—domestic or foreign—can have, so a government's strategy for bank privatization in EE involved choosing both a policy on foreign ownership and a method of privatization consistent with this policy (Bonin et al. 1998: 21). The entry of foreign banks into the EE banking sector was directly connected to privatization through a direct sales method; that is, auctions or tenders. These involved only a very few foreign *greenfield* banks, particularly in the initial years of transition. Following Bonin (1998), in this study, governmental policy that encourages (or

[123] Brada (1996) presented a full taxonomy of privatization methods. In addition to the privatization methods examined in this study, he also identified the *privatization through restitution* method, appropriate when property that was expropriated in the past can be returned to either the original owners or to their heirs. This method was only used in EE but not in bank privatization.

[124] The mass-privatization program has been seen as the biggest "switching point" in post-communist development (King and Hamm 2005: 54).

discourages) the entry of either new private banks or foreign banks as greenfield investments corresponds to privatizing the banking sector.

EE governments have chosen different strategies for bank privatization. While some countries have chosen to liberalize and privatize their banking systems, mostly to reputable foreign banks, and to strengthen the institutional capacity of their domestic financial systems, others, for example, a number of post-Soviet republics, along with Bulgaria, Romania, and Albania, chose not to genuinely break up the socialist banking system and instead to retain effective control of banks. SOBs in the latter three countries remained major stakeholders in industrial enterprises, either through the outstanding debts of these enterprises or through personal relations inherited from the communist regime. Governments have also used regulations to restrict new competition, particularly from foreign banks. For example, in Azerbaijan, a 1994 decree required state-owned enterprises to bank only with SOBs. Similarly, since 1992, Russia has imposed an official limit on the entry of foreign banks.[125]

Delayed privatizations and restrictions on foreign bank entry protect SOBs from competition. Financial systems remain financially repressed and dominated by large SOBs, which are able to preserve their relationships with those who have influence over enterprises, such as managers, other lenders, and the political elite, as well as their monopoly rents as the sole providers of funding to various enterprises. Financial repression is used to maintain soft budget constraints to state-owned and privatized enterprises through banks that absorbed the losses of those enterprises in the short run (Denizer et al. 2006: 566). Directed credits to certain industries at low interest rates on the basis of political connections encourage rent-seeking behavior and the misallocation of funds (Caprio et al. 2001: 6). Privatization has a strong potential

[125] The limit on foreign bank ownership was 12 percent until 2001 but was later increased to 25 percent.

to improve the functioning of a financial system in part by limiting harmful governmental interventions in allocating credit. Private ownership of banks also provides better incentives to discipline the risk-taking behavior of bank managers.

However, *Insider* privatization schemes—vouchers and management-led buyouts—do not improve financial institutional outcomes. The outcome of these schemes is an extensive cross-ownership between banks and industries that remains an *indirect* form of state ownership (Kornai 1995: 43–45). Hence, existing management remains firmly entrenched, and banks are not independent of state control. Insider privatization, therefore, does not credibly challenge incumbent banks and enterprises.

In EE, voucher privatization allowed citizens to use vouchers that were distributed free or at nominal cost to acquire shares in state-owned enterprises.[126] The attraction of the program was the speed in which state property was transformed and the egalitarian distribution of shares to the population. Mass privatization was also intended to destroy the strongest potential anti-reform coalitions, which consisted of managers and workers of state-owned enterprises (King and Hamm 2005).So, the decision to pursue mass privatization, and its specific program design, was primarily dictated by politics (Boycko et al. 1996).

Nonetheless, contrary to intentions, voucher privatization has brought new opportunities for incumbent banks to become involved in the ownership of industrial enterprises, mainly through their role in managing voucher privatization (investment) funds. Voucher distribution initially resulted in a widely held ownership structure, which impeded (foreign) strategic investors from taking an interest in a bank. Over time, domestic incumbent banks, through investment funds, acquired significant share

[126] The design of voucher privatization varied across countries. While the Czech voucher privatization program relied heavily on vouchers and prohibited the post-sale trading of stock, the Russian program privatized only small stakes (29 percent on average) in enterprises and allowed the unrestricted trading of vouchers (Katz and Owen 1997).

holdings in other banks and industrial enterprises (King and Hamm 2005). Voucher privatization in the Czech Republic resulted in cross-ownership between incumbent banks and enterprises (or even with the government). Banks acted simultaneously as owners and creditors of these enterprises and were thus motivated as owners to bail them out when they were in difficulty. We can expect that incumbent interests would support vouchers and private-placement methods of state divestiture because these do not erode their established monopolies (Ben-David 2003).

Voucher privatization was also sometimes used as a means to preserve domestic ownership and to impede foreigners from buying domestic industries. For example, one of the principal motives behind the voucher privatization program implemented by the Klaus government in the first half of the 1990s was to prevent foreign investors from the buying the then weak Czechoslovakian economy. Later on, the Czech government also prohibited or tacitly discouraged foreign ownership in the privatizing of banks.

Management-led privatization and other specific government programs allowed incumbent banks to acquire strategic shares in "crown jewel" enterprises and in other banks without investing a lot of money (Martin 2002, Eyal et al. 1998, Stark and Bruszt 1998). In 1995, the Russian government implemented a program called "loans for shares" that transferred control of twelve natural resource enterprises to a small group of powerful Russian banks at a fraction of their value.[127] This "wild privatization" in Russia allowed the largest banks in Moscow to become the dominant players in the Russian economy (Rutland 2005: 4). In Ukraine, the government

[127] The objective of the program was to finance the increased budget deficit. To this end, the Russian government contracted loans for about 1 billion dollars against the collateral of shares owned by the state in the most profitable natural resource industries. Because the government did not buy back the shares after the agreed-upon three-year maturity period, banks took ownership of valuable state assets (Gros and Steinherr 2004). For example, the Menatep bank obtained 78 percent of Yukos shares, and Oneximbank gained 38 percent of Norilsk Nickel shares (Popov 1999: 23).

introduced so-called surface privatization, allowing bank clients—former state-owned enterprises—to acquire large stakes in government banks and to distribute bank shares to the employees of these client enterprises and of the banks themselves (Barisitz 2005: 65). The extent of cross-ownership led to the rise of financial conglomerates and "financial oligarchs," especially in Russia and Ukraine (Rutland 2001 and 2005). When privatization allows a buyer to put only a little of his own capital into the bank, there is a danger that such a privatized bank will engage in risky activities (Mishkin 2006: 150).

The privatization of SOBs in EE was also directly linked to the privatization of state-owned enterprises.[128] As Stark et al. (2000) pointed out, in the East European "privatization race," the lack of private investors often resulted in "privatization" of state-owned enterprises to other state-owned enterprises. Thus, relations among enterprises were based not only on economic but also on political and social considerations and the state retained an important connection with state enterprises throughout the privatization process.[129] Insider privatization methods also allowed state-owned enterprises to become bank shareholders. Generally, when large enterprises are allowed to buy banks, they are likely to engage in connected lending (Mishkin 2006: 150).

In sum, contrary to the standard theoretical expectations that vouchers (and share-issues) will foster development of financial markets and improve corporate governance in finance, these strategies in EE allowed weakly regulated domestic incumbent banks to capture the state, preserving their political influence, positional

[128] Clarke, Cull and Shirley (2004) provided a good summary of a large body of literature on enterprise privatization.

[129] Some commentators labeled the outcome of these privatization strategies "managerial capitalism" (Eyal et al. 1998, Martin 2002).

rents, and the institutions that served their interests. Excluding foreign owners from privatization enabled politicians to sell off bank assets to domestic supporters and to powerful rivals at below-market value. Soft budget constraints and the pervasiveness of connected lending meant that banks were not motivated to pursue their debtors because they could rely on the government for support in dealing with debtor problems. This was the case for banks in the Czech Republic and Slovakia, and for state banks in Georgia, in Macedonia, and in other countries that adopted voucher privatization (Tang et al. 2000). Citizens have actually become owners of the worst-performing privatized assets, while the best companies have come under insider control, and asset-stripping has become widespread (Megginson and Netter 2001: 346).

The third privatization method, widely subscribed initial public offerings (IPOs), is politically attractive as a means of preserving domestic ownership. IPOs avoid the pitfalls of lending to parties connected to majority owners of the bank. However, in countries with underdeveloped capital markets structures (inexperienced investment banks and limited trading mechanisms), this method can lead to undesirable outcomes ranging from the inefficient share distribution to market manipulation (Andrews 2005: 23).

Because most transition economies have small, emerging capital markets, the privatization method that will increase the likelihood that the governance of the bank will be independent from the government as well as from the incumbent bank management is selling banks through tender or auction to a prominent foreign shareholder (Bonin et al. 1998: 5). Privatization to reputable international banks can quickly introduce independent governance into the financial system, helping to erode the rent-seeking of incumbents. Outside financiers have proved to be in the best position to mitigate problems that were present when incumbents dominated financial

markets. Foreign banks are strangers to local interest networks and prefer to gain market shares and profits through competition (Bossone et al. 2003: 24-25). Therefore, foreign bank entry introduces competition among financiers, giving the most viable domestic enterprises access to alternative funding sources. Foreign bank entry also drives rents of incumbent banks down from quasi-monopolistic levels in addition to imposing hard budget constraints on borrowing enterprises. It has been also empirically demonstrated that governments able to commit to property rights protection are more likely to privatize via asset sales (Megginson et al. 2000).[130] Foreign banking ties with enterprises are usually weak in terms of both debtor relations and equity investment, and are based on arm's-length rather than political connections. Foreign ownership thus reduces the potential for politicization of bank lending and increases the integration of financial markets (Bonin and Wachtel 1999).

In sum, financial systems that have a greater weight of foreign banks in financial intermediation tend to be more competitive and stable. On the other hand, privatization through vouchers, particularly when the government retains a significant share and thus continues to intervene in lending decisions, reduces the benefits of privatization and results in inconsistent economic policies.

Data Comparing Financial Systems in EE

The task ahead is to apply these distinctions empirically, first linking the mode of privatization to the ownership structure and institutional characteristics of the two types of financial systems: clientelistic, with a bank ownership structure dominated by incumbents (mostly SOBs); and open, with a higher share of foreign banks in financial intermediation. In this section, I explore how different privatization experiences led to

[130] A disadvantage of tender offers from a strategic foreign investor is the need to set a price administratively for the transaction. If the price is too low, the government is accused of having "sold" domestic interests to foreigners. If the price appears to be too high, or if a government restricts the offer of bank control, strategic investors may lose interest (Bonin and Wachtel 1999).

different types of financial systems in EE. Admittedly, few cross-sectional observations in my regional sample of countries are entirely independent because governments learn from one another. This is particularly true in international finance. However, this learning was neither linear nor systematic across the countries under examination.

Presenting my results relies mostly on graphic data presentation, bivariate relationships, partial regression plots, and a few regression models. My argument is based not only on these single statistics but on the entire body of evidence, including elite interviews and archival sources. I do not dispute that the openness of a national banking sector to foreign buyouts explains all financial structures. The empirical regularities I identify may serve to suggest the plausibility of this argument, however.

I expect that a greater openness of domestic banking sectors to foreign buyouts via tender offers would erode the power of SOBs and lead to more open, competitive financial systems.[131] The impact of foreign capital on the preferences and actions of domestic groups within countries is likely to grow with the entry of foreign banks. To investigate the relationship between the mode of privatizing banks and enterprises and the financial system ownership structure, I created the privatization method data set. I operationalize the privatization method used by the country by creating a dummy variable, assigning a value of 1 if privatization was done through direct sales or 0 if the country privatized through insider privatization—either voucher privatization with significant concessions to insiders, or management-employee buyouts—or if no privatization took place. I coded qualitative data on privatization using the various years of the European Bank for Reconstruction and Development (EBRD) Transition

[131] Rajan and Zingales (2003) showed a negative correlation between direct barriers to entry into the industry (measured by the number of procedures necessary to open a business) and financial development.

Reports. I choose this time-series index over a pure cross-sectional index because I want to capture important changes in the privatization method over time. For example, switching from insider privatization to direct outsider sales could have resulted in transforming the banking system, leading perhaps to a change in the exchange rate regime, which a purely cross-sectional variable would not explain. I report only "primary" and "secondary" privatization methods.[132] I use a cumulative measure of privatization because I expect its effect on financial development to show with some time lags.

The privatization variable also serves as a proxy for restrictions on foreign investments in the domestic banking sector. These restrictions often reflect the nationalist attitudes of governments, which tend to be reluctant to lose domestic control of large institutions that evoke pride and nationalistic feelings. The privatization variable has some additional limitations. First, governments can transfer their share of ownership in SOBs through mergers and acquisitions. Second, governments faced with soaring budget deficits and banks with large portfolios of nonperforming loans are more likely to liquidate SOBs than to privatize them. Indeed, many post-Soviet republics liquidated government banks after the banking crises of the 1990s.

I perform an exploratory data analysis by examining the bivariate relationship between the direct-sales method of privatization and foreign bank assets (figures 3.2 and 3.3). Foreign bank assets are the shares of total bank assets held by these banks exceeding fifty percent a year, as reported in the EBRD Transition Reports. As the

[132] Other scholars operationalized privatization methods in EE differently. For example, Garibaldi et al. (2001) constructed three indicator variables: privatization through direct sales, privatization through auctions involving vouchers, and management-employee buyouts. They assigned a value of 1 to the series if the method constituted the "primary" privatization method during the year, a value of 0.5 if it constituted the "secondary" privatization method, and a value of 0.25 if it constituted the "tertiary" method. If no privatization took place, these scholars assigned a value of 0 to all three indices. The disadvantage of this classification method is that it is somewhat subjective and arbitrary.

graphs show, there is a clear positive correlation between the two: countries that privatize their banks through tenders or auctions tend to have financial systems with a higher share of foreign banks in financial intermediation. The correlation is significantly positive, and regression estimates (not reported) show that it persists after correcting for the level of Gross Domestic Product (GDP).

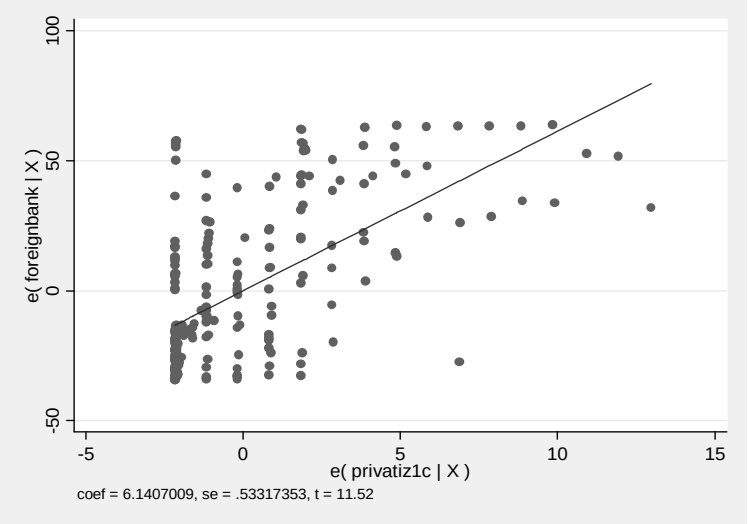

Figure 3.2: Direct sales method (used as a primary method of privatization) and asset share of foreign banks of total banking assets, 1990–2004

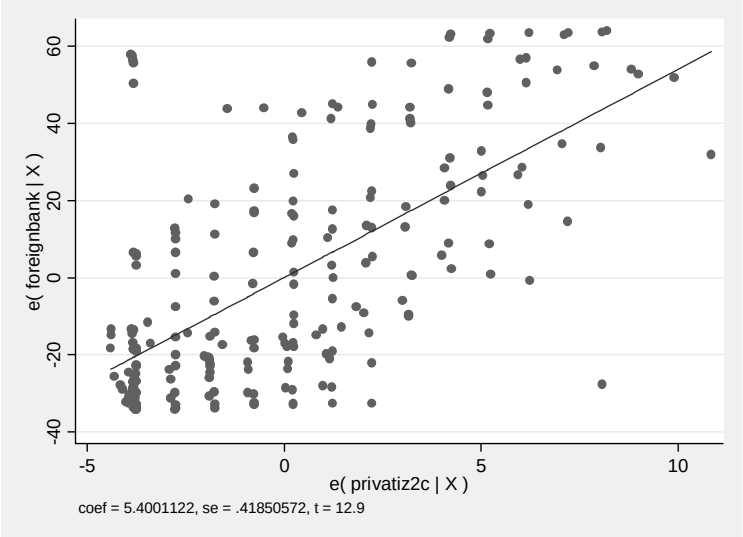

Figure 3.3: Direct sales (used as a primary and secondary method of privatization) and asset share of foreign banks of total banking assets, 1990–2004

In spite of privatization, the banking sector in EE remains one of the most state-controlled sectors for many EE economies. Financial systems in countries that delayed privatization or that privatized SOBs through various insider privatization schemes are yet dominated by state bank assets. State bank asset shares are the shares of majority assets of SOBs in total banking sector assets, as reported by the EBRD Transition Reports.[133] In the extreme cases of clientelistic finance systems that delayed or introduced insider privatization schemes, such as Albania, Azerbaijan, Belarus, Uzbekistan, and Turkmenistan, the government has controlled over 50 percent of bank assets throughout the transition (figures 3.4 and 3.5).[134] In Turkmenistan, the share of SOBs has dramatically increased of late, and the government had nearly full control over the banking sector in 2004: seven banks control 95 percent of all bank loans in the local currency and 100 percent of all hard currency–denominated loans.[135] This control facilitated the preservation of patron-client ties between clientelistic interest groups and their bureaucrat patrons. In the banking sectors of the aforementioned countries, foreign capital has a very limited role. The asset share of foreign banks is less than 10 percent, with the exception of Belarus, which has recently increased foreign bank presence in its market. In addition, the foreign bank presence on the market of many post-Soviet republics is usually Russian rather than Western.

[133] The state includes the federal, regional, and municipal levels as well as the state property fund and pension fund.

[134] Kazakhstan, the Kyrgyz Republic, Russia, Ukraine, and Uzbekistan all delayed reforms or introduced mass privatization, but they allowed the exchange of privatization certificates outside the stock exchange (Golodniuk 2005: 10).

[135] Turkmenistan and Azerbaijan are resource-rich countries, and such countries have usually high levels of rent-seeking (Hefeker 2007).

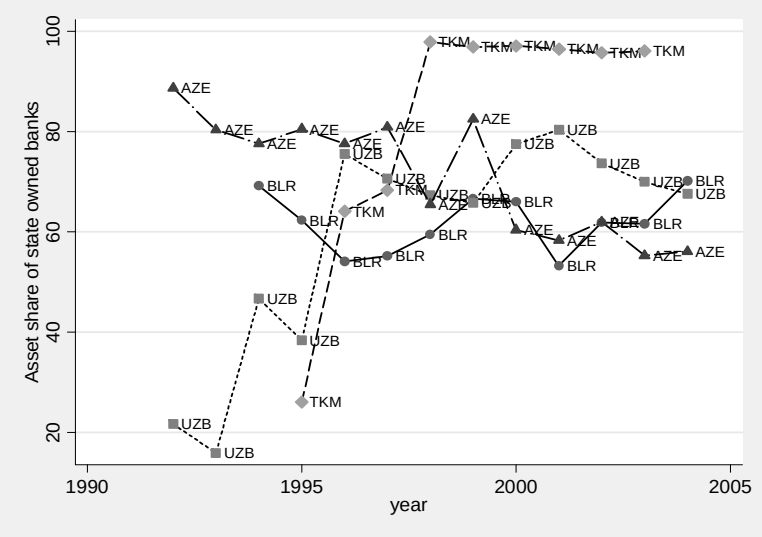

Figure 3.4: Clientelistic systems in Azerbaijan, Belarus, Uzbekistan, and Turkmenistan: Asset share of SOBs of total banking assets

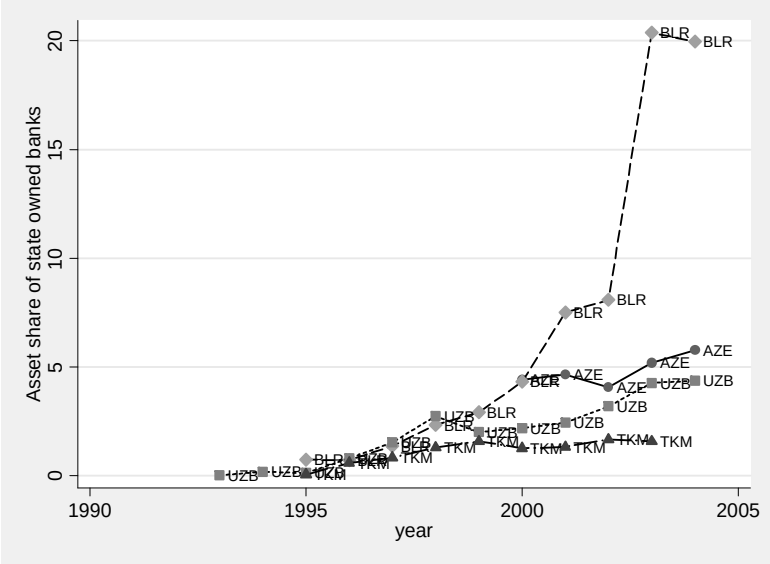

Figure 3.5: Clientelistic systems in Azerbaijan, Belarus, Uzbekistan, and Turkmenistan: Asset share of foreign banks of total banking assets

Nevertheless, the continued state ownership of banks has often been harmful to EE societies. Governments in some EE countries with clientelistic financial structures accelerated SOB privatization to reputable international banks in order to bring independence from incumbent groups to the banking sector, and to build more

competitive finance systems. This strategy was prompted by SOB failures, the high cost to the state of keeping banks, financial instability, systemic banking and financial crises, and severe economic collapse late in the transition. Because fiscal costs and losses in output associated with crises are significant and visible, banking and financial crises present reformers with unique opportunities to change policies, including privatization policies in banks (and industries) (Bossone et al. 2003: 24).[136]

As argued above, in the Czech Republic, the Klaus center-right government was resistant to foreign bank ownership. Only several bank failures and the currency turmoil in 1997 paved the way to re-evaluate the role of banks. The new social-democratic government led by former central bank governor Josef Tošovský opened up the ownership of Czech banks to foreign institutions. The second successor country of the former Czechoslovakia, Slovakia, also started with voucher privatization, but it was able to implement stricter regulations on investment funds limiting the extent of cross-ownership between banks and industries. [137] However, the government of the populist and authoritarian Prime Minister Vladimír Mečiar adopted a law banning privatization of the three largest SOBs in order to continue using those banks to direct credits to large exporters.[138] A consequence of this politicized lending and the short-term speculations of banks was a destructive credit increase on the market, leading to a

[136] The fiscal and quasi-fiscal costs of the banking crises (including bank restructuring and deposit compensation) ranged from 7 to 42 percent of the output for the Central European countries, from 0.1 to 18 percent of output for the CIS countries, and from 2 to 3 percent of the output for the Baltic countries (Tang et al. 2000). In most CIS countries, enterprises, banks, and depositors were left exposed rather than bailed out through recapitalization (Sherif et al. 2003: 71).

[137] However, similarly to the Czech Republic, one of the outcomes of the voucher method in Slovakia was the emergence of "secretive" private financial groups with political ties like the Penta Group, J&T Group, and Istrokapital, which became significant economic players. Author's interview with Juraj Renčko, former Advisor to the Minister of Finance, and the Head of the Coordination Unit for Bank and Enterprise Restructuring and Privatization (1999–2002), December 6, 2005, Bratislava.

[138] The Slovak Parliament approved delaying privatization of VÚB, Slovenská Sporiteľňa, Investičná a Rozvojová banka, and the Slovenská Poisťovňa insurance company until 2003.

run on banks. A new pro-Western government led by Mikuláš Dzurinda, which came into power in October of 1998, accelerated privatization to foreigners, which pulverized incumbent coalitions of banks and industries linked to the previous government.

In Bulgaria, delayed privatization led to an unsustainable vicious circle when the government continued to subsidize ailing state-owned enterprises through SOBs. Because most of these credits turned out to be uncollectible, banks accumulated losses, which were in turn refinanced by the central bank. The banking and currency crisis became the logical consequence, which culminated at the beginning of 1997 with hyperinflation, a massive depreciation of currency, and the collapse of several banks. The economic crisis was accompanied by a deep political crisis and mass demonstrations. The socialist government of Zhan Videnov was forced to resign; a new anti-communist government led by Ivan Kostov privatized the country's first state bank in 1997.[139]

In Croatia, which in 1995 had virtually no foreign investments in the banking sector, the ten largest banks in the country were mostly foreign-owned by 2002. A particularity of Croatia's trajectory was that since 1957, domestic commercial banks were not owned by the state but were socially owned and controlled by worker self-management enterprises. After the dissolution of the former Yugoslavia, where monetary policy was a major source of income redistribution, the Croatian government continued the inflationary financing of its expenditures via an inflation tax (Kraft 1995: 479). This experience proved disastrous to the Croatian banks that were facing large amounts of bad loans and currency mismatches on their balance sheets. The Croatian government decided to select four major banks (Slavonska, Splitska,

[139] Author's interview with Nikolay Nenovsky, Member of the Governing Council of the BNB, June 26, 2007, Sofia.

Riječka and Privedna) for rehabilitation, which resulted in their nationalization so that four large SOBs were created in Croatia in 1995 before being privatized to foreigners. Albania has also slowly started to privatize banks after the damage that was done by the pyramid schemes in 1997, but shares of SOBs still exceeded 50 percent in 2004.

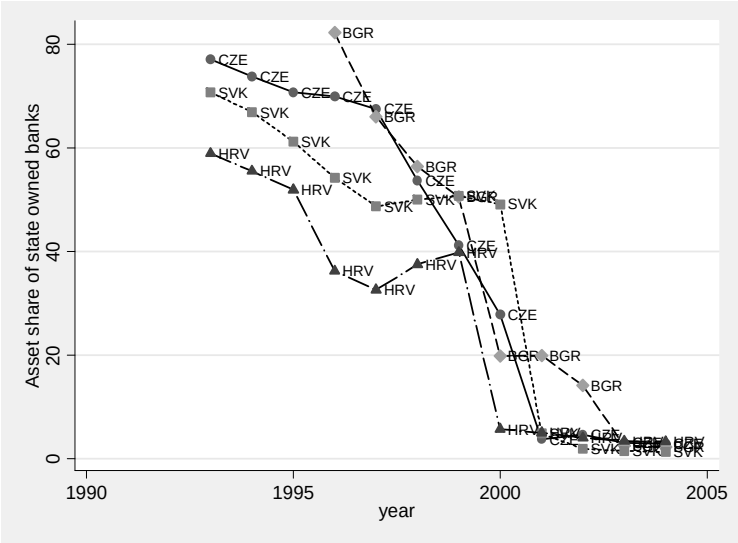

Figure 3.6: From clientelistic to open finance in Bulgaria, the Czech Republic, Croatia, and Slovakia: Asset share of SOBs of total banking assets

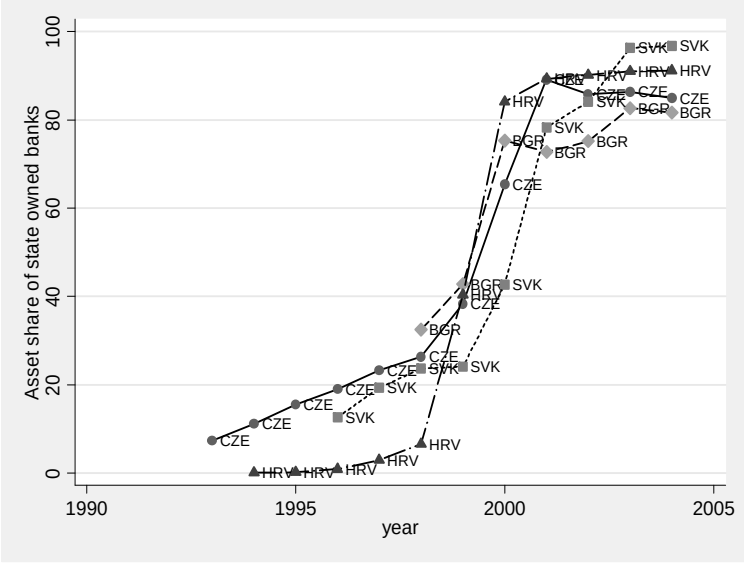

Figure 3.7: From clientelistic to open finance in Bulgaria, the Czech Republic, Croatia, and Slovakia: Asset share of foreign banks of total banking assets

Although Russia, Ukraine, Moldova, and several other post-Soviet republics suffered severe banking financial crises in 1998, these did not bring major changes in their approaches to bank privatization or and liberalization of foreign entry into their banking sectors. At the end of 2001, in Russia more than 460 banks were still state-owned, with as many as 679 having shares or stakes from all public institutions (including the central bank that owns the largest bank: Sberbank).[140] The state held controlling stakes in 62 banks and blocking shares in 80 banks (Sherif et al. 2003: 46).[141] Even banks not formally owned by the state remain under influence of state bureaucrats (often via a "golden share") especially at regional and municipal levels.[142] Ukraine has a smaller share of SOBs, but they have a strategic importance and are used for political patronage (Sherif et al. 2003: 47) (table 3.3).[143]

In sum, over time, EE countries decreased state ownership in the banking sector (see table 3.3). While Central Europe saw a decline in state ownership of banks as the result of privatization, in the Baltics, this decline also resulted from the consolidation of SOBs through liquidation or mergers and a large entry of foreign banks. In many CIS countries and in Romania, governments closed and liquidated failing banks (Tang et al. 2004). State bank assets in Central Europe and the Balkans were more prominent than those in CIS countries because hyperinflation wiped out

[140] The data on state ownership in the Russian banking sector are very limited, though.

[141] The opposite trend can be observed in Russia. The Putin government created a new Bank of Development in May 2007 led by new group of oligarchs, the so-called *silovarchs*, with close links to the government (Volkov 2008).

[142] The 1998 financial crisis weakened Russian banks. Some banks were renationalized, e.g., the taking over of the viable Promstroybank by Vneshtorgbank in 2005, or they were owned or controlled by oil producers such as Gazprom, LUKoil, or Yukos. Oil companies use these banks to provide cheap credit to their shareholders and owners (Vernikov 2007: 12, Gnezditskaia 2005).

[143] The smaller shares of SOBs in Ukraine also reflect the fact that its large agricultural bank, Ukrayina, underwent liquidation in 2001.

asset values in the latter. Among the CIS countries, Armenia and Georgia have fully eliminated state ownership in the banking sector.

Table 3.3: Asset Share of SOBs of Total Banking Assets

CEB &SEE	*1996*	*2004*	*CIS*	*1996*	*2004*
Albania	93.75	51.93[1]	Armenia	3.19	0.00
Czech Republic	69.93	2.88	Azerbaijan	77.58	56.09
Estonia	6.56	0.00	Belarus	54.10	70.20
Hungary	15.31	6.65	Georgia	0.00	0.00
Latvia	6.86	4.04	Kazakhstan	28.44	3.72
Lithuania	54.02	0.00	Kyrgyz Republic	4.99	4.07
Poland	69.82	21.72	Moldova	na	17.64
Slovakia	54.18	1.31	Russian Federation	36.98[2]	na
Bulgaria	82.18	2.27	Tajikistan	5.26	12.23
Croatia	36.20	3.26	Turkmenistan	64.11	96.11[1]
FYR Macedonia	0.00	1.88	Ukraine	13.48[2]	8.00
Romania	80.90	7.54	Uzbekistan	75.55	67.58
Slovenia	40.74	12.57			

[1]Asset share of SOBs in 2003
[2] Asset share of SOBs in 1997
Source: EBRD Transition Reports, various issues.[144]

Kazakhstan has also been able to reduce the assets of SOBs substantially since 1998, but this decline was mainly due to the liquidation of SOBs. An important feature of the bank ownership structures in Russia, Ukraine, and other CIS countries was the large number of small "private" startup or spin-off banks of the Gosbank branches. This type of ownership transformation was a "proxy" for bank privatization, but the resulting banks continued to operate as pocket banks, or captives of the state enterprises they financed (Sherif et al. 2003: 37–38).[145]

[144] I am grateful to Anita Taci, an EBRD economist, for sharing the bank ownership data with me.

[145] Similarly as under socialism, enterprises in many CIS countries engage in barter and tolerate payment arrears, i.e., uncollectible debts between enterprises, rather than rely on formal financial

On the other hand, those societies that began to privatize their SOBs to foreign strategic investors were able to reduce the negative effects of the rent-seeking networks of incumbent financiers and industrialists and to avoid severe economic crises. Hungary was the first to use a case-by-case method of privatization to foreign banks. The Hungarian government allowed three foreign banks to operate as early as 1985. By mid-1997, eight of the top ten Hungarian banks were mostly foreign-owned (Bonin 2004). Poland initially adopted a positive stance toward foreign ownership of banks, and then backtracked, before again opening its banking sector to foreigners and encouraging greenfield investments. The privatization process in Poland was eclectic and changed over time, with the emphasis shifting from a mix of IPOs and minority stakes to strategic investors, to IPOs exclusively and then back to direct sales to foreign strategic investors.[146] Laar's government in Estonia moved aggressively to liquidate weak SOBs from the outset of the transition in the early 1990s, to consolidate them and to attract foreign investment, mostly from Scandinavia. This move has managed to destroy the political influence of the pre-independence coalition of state and party bureaucrats and managers of state banks and enterprises.[147] In 2004, foreign banks held the largest share of the total banking assets from all EE countries (98 percent). As Table 3.4 shows, the extent of the banking system internationalization still varies considerably within the EE region.[148]

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institutions. For example, in Ukraine, net enterprise arrears were estimated to be 98 percent of GDP in 1998 (Sherif et al. 2003).

[146] Author's interview with Stefan Kawalec, former General Director in the Ministry of Finance and the Chief Advisor to Deputy Prime Minister Balcerowicz (1989–1991), Deputy Minister of Finance (1991–1994), July 16, 2006, Warsaw.

[147] Author's interview with Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999–2002), July 19, 2007, Tallinn.

[148] In Central Europe, the share of foreign banks is as much as 80 percent, controlled by less than a dozen international banks, mostly European, including Unicredito (Italy), Erste Bank (Austria), KBC (Belgium), and Societé Génerale (France). It is interesting to note that the share of foreign banks is very

Table 3.4: Asset Share of Foreign Banks of Total Banking Assets

CEB &SEE	*1998*	*2004*	*CIS*	*1998*	*2004*
Albania	14.36	47.11[1]	Armenia	40.50	56.71
Bulgaria	32.47	81.61	Azerbaijan	Na	5.77
Croatia	6.60	91.16	Belarus	2.34	19.97
Czech	26.36	84.91	Georgia	20.06	58.11
Republic	90.22	97.96	Kazakhstan	na	5.54
Estonia	11.42	47.28	Kyrgyz Republic	35.81	70.05
FYR					
Macedonia					
Hungary	59.20	63.04	Moldova	22.40	33.58
Latvia	79.12	48.56	Russian	10.15	7.57
Lithuania	50.69	90.76	Federation	NA	NA
			Tajikistan		
Poland	17.36	71.32	Turkmenistan	1.30	1.58[1]
Romania	15.12	58.52	Ukraine	9.17	12.07
Slovak	23.69	96.73	Uzbekistan	2.74	4.37
Republic	4.86	20.06			
Slovenia					

[1]Asset share of foreign banks in 2003.
Source: EBRD Transition Reports, various issues.

As argued previously, I expect that those societies that transferred bank ownership from the government through auctions and tenders to foreign strategic investors are more likely to develop an open financial system with a strong regulatory and supervisory framework. To investigate this relationship, I use the Fries (2005) measure of financial development, based on the annually published EBRD Transition Report, which has three dimensions and is the simple average of three variables: 1) the reform of banking institutions and regulations,[149] 2) the share of private banks in total bank assets, and 3) the share of foreign banks in total bank assets. In figures 3.8 and 3.9, I

low in Western Europe, where only 15 percent of banks are foreign-owned (*The Economist*, April 28–May 4, 2007:13).

[149] A more detailed description of this index, which is the primary indicator of financial development in my econometric models, is provided in chapter 4.

graph this measure of banking development against the cumulative measure for the method of divestiture of state ownership. There is a clear positive correlation between the two: countries that privatize through direct sales tend to exhibit a more open, competitive, and better regulated financial system. In 2001, a clear divide is apparent between the former countries and those that were caught in a vicious cycle of financial institutional backwardness as a result of their liberalization and privatization choices.

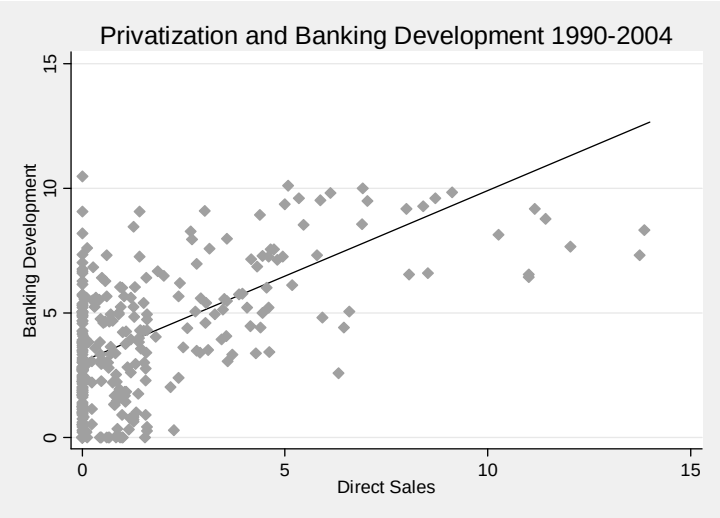

Figure 3.8: Cumulative privatization through direct sales against financial development, 1990–2004

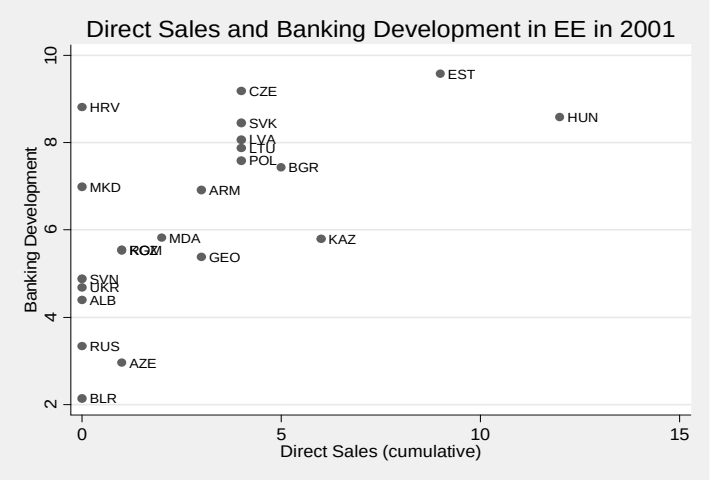

Figure 3.9: Cumulative privatization through direct sales against financial development in 2001

Table 3.5 shows the results of my test of the above hypothesis. As the estimates show, privatization through direct sales has a positive and statistically significant effect on financial system development. This is true even if I control for the influence of incumbent interests on financial development (proxied by openness to trade, measured as exports plus imports of goods as a share of GDP over the period 1990–2004), following Rajan and Zingales (2003) example and using a fixed effects model.[150] Openness, however, becomes statistically insignificant in fixed effects panel regressions.

Table 3.5: Financial Development and Privatization

	(i)	(ii)	(iii)	(iv)
Direct Sales	0.664***	0.550***	0.910***	0.713***
	(0.047)	(0.030)	(0.060)	(0.034)
Openness	0.008*	0.007*	0.007	0.002
	(0.004)	(0.003)	(0.005)	(0.004)
Constant	2.408***	1.870***	2.182***	1.960***
	(0.332)	(0.300)	(0.460)	(0.386)
R^2	0.43	0.52	0.43	0.52
Observations	301	301	301	301

The standard errors are in parentheses. (*) indicates significance at the 10% level, (**) at the 5% level, (***) at the 1% level.
(i) Pooled regression with robust standard errors, if direct sales used as a primary privatization method.
(ii) Pooled regression with robust standard errors, if direct sales used as primary and secondary privatization method.
(iii) Fixed effects panel regression, if direct sales used a primary privatization method.
(iv) Fixed effects panel regression, if direct sales used as primary and secondary privatization method.

[150] The Breusch-Pagan test indicates that there are significant country level effects, implying that pooled OLS would be inappropriate. The results of the Hausman test indicate that the random effects model is not appropriate, either.

In some clientelistic systems (but not in others), SOBs were also able to capture central banks, which then became the main vehicle of unsustainable monetary policies and excessive lending of last resort to banks. As illustrated in chapter 6, in Bulgaria, the managers of state enterprises and banks were closely connected to the members of the banking supervision department at the Bulgarian central bank, which provided discretionary refinancing to these groups. The annual laws also required that the central bank print money to partially finance the government deficit, which was in direct violation of the central bank law.[151] The governor of the Central Bank of Russia, Victor Geraschenko (who previously chaired the Gosbank), was notorious for increasing the money supply by bailing out problematic enterprises and their lenders (Berglof and Bolton 2002: 79).

Figures 3.10 and 3.11 show the bivariate relationship between government ownership of banks and central bank independence. As expected, countries with a larger presence of SOBs in the financial system have less independent monetary authorities, although the correlation is not very strong. In contrast, when foreign banks dominate financial intermediation, central banks tend to have more autonomy in conducting monetary and exchange rate policies.

[151] Author's interview with Lubomir Christov, former Chief Economist and Member of the Managing Board of the BNB (1991–1994), June 29, 2007, Sofia.

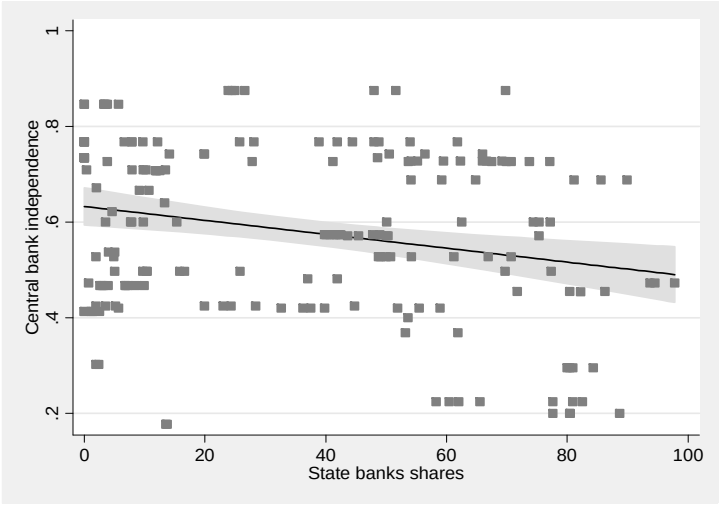

Figure 3.10: Asset share of SOBs of total banking assets against central bank independence

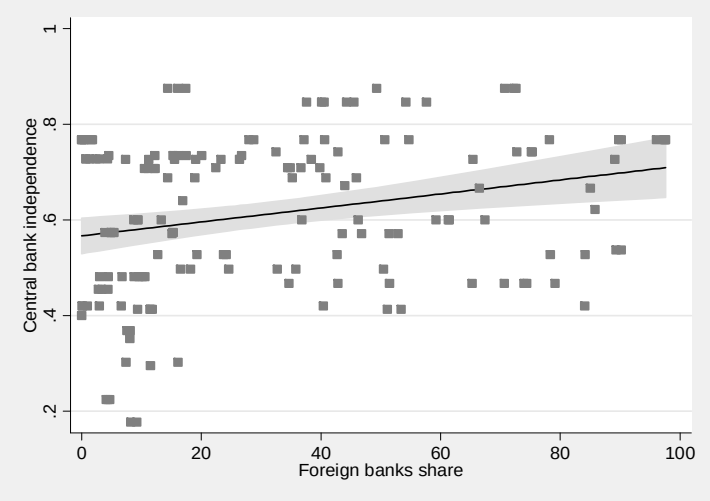

Figure 3.11: Asset share of foreign banks of total banking assets against central bank independence[152]

The distorted economic policies resulting from the patronage or preferential treatment of incumbents were symptoms of the underlying institutionally weak financial systems dominated by SOBs. The brief discussion that follows on the consequences of bank ownership structures dominated by incumbent domestic banks is summarized

[152] The indices of central bank independence are from Popova (2000) and Bodea and Popova (2005).

schematically in table 3.6, which presents statistical data on prudential regulatory frameworks (columns 1–2), bank intermediation (column 3), and banking fragility (column 4).

Table 3.6: Selected Indicators of Banking Development

	Number of banks (1995)	*Bad loans (in % of total loans, 1997)*[153]	*Loan-deposit rate spread (1996)*	*Banking crises*
Albania	6	91.3	7.2	1992–
Armenia	35	7.9	34.2	1994–1996
Azerbaijan	180	19.9	20.0	1995–
Belarus	42	12.5	29.9	1995–
Bulgaria	41	13.0	48.8	1996–1997
Croatia	54	8.2	16.9	1996
Czech Republic	35	19.9	5.8	1989–1991, 1996
Estonia	19	2.1	7.6	1992–1995
Georgia	101	6.6	27.3	1991–
Hungary	43	6.6	5.1	1991–1995
Kazakhstan	130	6.0	24.1	No data
Kyrgyz Republic	18	7.6	28.3	1990s
Latvia	42	10.0	14.1	1995–
Lithuania	15	28.3	7.6	1995–1996
FYR Macedonia	6	21.1	8.0	1993–1994
Moldova	25	26.0	11.3	No data
Poland	81	11.5	6.1	1992–1995
Romania	24	56.5	14.7	1990–
Russian Federation	2297	9.1	91.7	1995, 1998–1999
Slovakia	33	33.4	4.6	1991, 1996–1997
Slovenia	39	10.0	7.5	1992–1994
Tajikistan	18	3.0	13.0	1996
Turkmenistan	67	13.9	70.0	No data
Ukraine	230		46.3	1997–1998
Uzbekistan	31	0.4	22.0	No data

Source: Di Caprio and Klingebiel (2003); EBRD Transition Reports, various issues.

[153] In many post-Soviet republics, which experienced hyperinflation at the beginning of the transition, the problem of bad loans was initially solved by wiping out the real value of the loans from the communist regime (Murinde et al. 2001: 450).

An examination of this table suggests the following: First, a liberal policy of issuing banking licenses and inadequate financial regulation and banking supervision led to a proliferation of private banks whose new owners were state enterprises or party-affiliated institutions. Whereas in Central Europe private banks were created mostly through the privatization of SOBs (spin-offs of the central bank), in the post-Soviet republics, many *de novo* domestic private banks were born under lax entry requirements (Coricelli 2001). During the creation of many new banks from the branches of Zhilsotsbank in Russia, branch managers were allowed to choose the assets for the new private banks, e.g., Mosbusinessbank, so they were essentially acquiring state assets at a zero price (Andrews 2005: 23). In the first wave of financial liberalization in Russia, two new types of banks, linked to the state bodies, were established: zero banks (created by party affiliated institutions) and industry banks (established by state enterprises) (Johnson 2000: 36–37). As a result of lax licensing requirements, the Russian banking system consisted of 2,500 banks in 1994 (Johnson 2000).

Second, a weak regulatory framework has not deterred SOBs and politically connected domestic private banks from taking on excessive risk. These banks have engaged in short-term speculations in international markets that in combination with liberalized capital flows have been a source of currency mismatches on bank balance sheets, banking sector fragility, and balance-of-payment crises (Kaminsky and Reinhart 1999, Demirguc-Kunt and Dertragiache 2000).[154]

Third, the predominant role of SOBs also led to pervasive connected lending to loss-making state enterprises and to the accumulation of huge proportions of bad

[154] Johnson et al. (2000) showed that among emerging markets liberalizing capital flows, those with weaker political and financial institutions experienced more severe crises during the 1990s.

loans. Concentrated industrial structures and large state-owned enterprises of the central planning period enhanced the capacity of various enterprises to organize as special-interest lobbying groups. As a legacy of financial repression, SOBs in most EE countries inherited nonperforming bank loans from the previous periods of directed lending, though not from the same levels.[155] Nonetheless, bad loans were also the outcomes of deficient credit-assessment procedures and the politicized lending of banks to state-owned industries during the post-communist period. The lending portfolios of SOBs became heavily concentrated among a few enterprises and industrial sectors. Lack of competition in the banking sector and an inflationary environment allowed SOBs to benefit from large net spreads between loan and deposit rates. Therefore, not only were incentives or mechanisms to effectively enforce debt service missing, but also foreclosing on large borrowers—state-owned enterprises—threatened bank solvency. Banks were expecting their losses to be covered by the government (Dyker 2001).[156]

Conclusion

The argument I have outlined in this chapter is that the timing and mode of the privatization and internationalization of a nation's financial sector result in two principal types of financial systems: open and clientelistic. After the collapse of communism, democratizing EE societies faced strong distributive pressures from incumbent interests demanding protection. If policy makers delayed the privatization of SOBs (and industries), or used insider privatization schemes restricting foreign

[155] The collapse of the Council of Mutual Economic Assistance (CMEA) and restrictive economic policies during the transition led to rapid increases in inter-firm debt and bad loans, reaching 23–35 percent of total outstanding loans (McDermott 2004a: 9).

[156] These were off-budget subsidies that allowed governments to support loss-making enterprises without breaking their promise to the IMF to balance the budget. Balanced budgets conditioned IMF financial loans.

bank entry, the *status quo*—that is, the financially repressed system—benefiting rent-seeking SOBs and enterprises prevails. On the other hand, liberalization of foreign entry is a way to increase the share of foreign banks, to change the distribution of power in domestic financial markets, and to limit harmful government interventions in allocating credit.

Clientelistic systems remain dominated by SOBs. Weak monetary and regulatory institutions, and economic policies including a monetary policy of high inflation, expansive credit and fiscal policies, excessive bailouts of failing banks and loss-making enterprises that reduce the general welfare of the population are then likely to be symptoms of the political influence of incumbents. On the other hand, in open systems, an increased participation of foreign banks in financial intermediation has a positive effect on the quality of regulatory and monetary institutions, and a disciplining effect on government monetary and fiscal policies. Applying this argument explains a great deal of the variation in financial systems development across EE countries.

I have also shown that a country's financial system is not static but exhibits some variation over time. Incumbent financiers and industrialists become entrenched in "good" times, but banking and financial crises tend to undermine the credibility of those interests that had favored status-quo policies, which are usually responsible for those crises. The incumbent interests and institutions may fragment and weaken (politically and financially), their interests may diverge, and new constituencies favorable to financial liberalization can be created. The incumbents are politically and financially weak to form effective anti-reform coalitions (Maxfield and Haggard 1996). After the systemic banking and financial crises in the second half of the 1990s, some EE countries privatized and opened their financial sectors to foreign investors, which had some observable convergence impacts on their financial systems. Perhaps,

as Benjamin Cohen (1996: 288) noted, “the globalization of finance has obviously increased pressures for general policy convergence toward an agenda set by investors.”

In the subsequent statistical chapter, I will develop a quantitative model testing the effect of different financial systems on the choices and sustainability of their exchange rate regimes for cross-section, time-series data on 25 transition economies in EE over the period 1990–2004. I will also employ a comparative case method in the qualitative chapters by tracing the processes of exchange rate policy making in four countries—Bulgaria, the Czech Republic, Poland, and Estonia—with a special emphasis on variation in the financial ownership structures, institutions, and processes in which these policies were conducted.

CHAPTER 4

EMPIRICAL TESTS

In chapter 2, I developed a theory that links financial interests and structures to exchange rate regime choices; also,; also, I specified hypotheses and implications that derived from that theory. For this chapter, I conducted various statistical tests that estimate the importance of a financial hypothesis, while controlling for the other economic and political explanations of actual exchange rate regime choices, discussed in chapter 1. Another set of tests estimates the influence of the same variables on the officially proclaimed exchange rate regimes. The principal hypothesis that will be tested in this chapter is that financial systems dominated by foreign and private domestic banks, accompanied by strong monetary and regulatory institutions increase the probability that a country would pursue a fixed exchange rate regime.

The first section describes the data used in the tests. The second section discusses the operationalization and measurement of the dependent variable—exchange rate regime—followed by a brief review of the evolution of exchange rate regimes in EE. The fourth section outlines the main relationships of the model from the literature review in chapter 1 and the theory in chapter 2 and discusses how the indicators of the key variables are developed. The primary analysis uses binary and multinomial logistic models on panel data. Also addressed in the analysis is the question of endogeneity and causality that arise in this context by using an instrumental variables approach via the generalized method of moments estimations. The analysis proposes the method of banking and industrial privatization as a new instrument for financial development. The instrument is derived from my theory of financial development in EE presented in chapter 3; where I established that privatization through direct sales to foreign investors creates a greater incentive for

financial institutional building. The econometric analysis underlines the positive influence of the level of financial development, defined here by the degree of financial openness and quality of banking supervision and regulation, on the probability of adopting and sustaining a fixed exchange rate regime. While financial system development was the variable of interest in chapter 3, it becomes the primary independent variable in this chapter. A further discussion of the results, in the light of the broad qualitative assessment of the exchange rate data in transition economies and the evidence of the case studies, is left to chapters 5–8.

The Sample

The test of the above hypotheses makes it possible to assess both the impact of the financial sector on exchange rate policy determination and the variation in that impact across countries and over time. As a principal empirical test, a panel data (a cross-section and time-series data set of twenty-five countries of EE from 1990–2004) is used to estimate a series of logit models with a binary exchange rate regime index as the dependent variable.[157] Data limitations preclude expanding this sample either temporally or cross-sectionally. The year 1990 is taken as the start of the economic transformation in the post-communist region.[158] Before 1990, developments occurred mostly in the political realm, related to the process of democratization. In the

[157] Some authors (Bénassy-Quéré and Couré 2002) recommend cross-section rather than panel data estimations, arguing that the choice of an exchange rate regime should depend on structural variables that are more country-dependent than time-dependent. Nonetheless, estimating by using panel data has several advantages over purely cross-sectional estimating. First, it allows taking into account how financial development over time within a country has influenced the country's exchange rate policies. Using a panel, I gain degrees of freedom by adding the variability of the time-series dimension. Second, in a cross-sectional regression, any unobserved country-specific effect would be part of the error term, potentially leading to biased coefficient estimates, while panel context enables controlling for unobserved country-specific effects.

[158] I use annual data, rather than quarterly data because my model also includes institutional variables that tend to be sticky. Quarterly data would introduce unnecessary correlations and little additional information. (Author's conversation with David Freedman, Spring 2006, Berkeley.)

economic realm, the foreign exchange regimes were unreformed, and currencies were not convertible. The sample period includes the years during which EE countries experienced an economic slowdown and financial turmoil, for example, the Russian financial crisis of 1998, as well as the years of economic growth. For the new countries building independent statehood after the collapse of communism, the series starts with independence.[159]

The Dependent Variable

The dependent variable in this study is treated as a binary exchange rate regime index: countries either float or fix. I examine the probability that a country will pursue or maintain a fixed exchange rate regime at time *t*.[160] Measuring the degree of exchange rate regime flexibility is the main challenge of the empirical analysis of exchange rate regime choice. The most widely used measure is based on the official IMF classification from the International Financial Statistics database and explained in more detail in the *Annual Report on Exchange Rate Arrangements and Restrictions.* The official regime is the regime that national authorities annually declare to the IMF. Recent empirical studies have provided evidence that the evaluation of adjustments in central parities and foreign exchange market interventions can generate exchange rates quite different from the official arrangements. Therefore, the policies that countries claim to be following differ from the actual outcomes of these policies. On the one hand, Calvo and Reinhart (2002) show that many countries officially claim to run floats but intervene frequently in their foreign exchange markets to reduce exchange

[159] For the Czech Republic and Slovakia before 1993, I used the data reported for Czechoslovakia.

[160] This dichotomy is not optimal in accounting for the great diversity of exchange rate arrangements in EE or for tracing the evolution of exchange rate regimes within individual countries. It also sacrifices valuable information about intermediate regimes. However, it is appropriate to test the current hypotheses. Fix versus float dichotomy is a metaphor for less or more flexible regimes. Adding additional hypotheses for other types of regimes would unnecessarily make my central argument fuzzy and less amenable to systematic testing. I thank Barry Eichengreen for this remark.

rate volatility, although the monetary authorities have no official commitment to maintaining the parity. This behavior is often referred to as the "fear of floating" phenomenon. On the other hand, Gosh et al. (1997) and Levy-Yeyati and Sturzenegger (LYS) (2000, 2005) argue that countries that frequently adjust the central parity can make an officially fixed regime resemble one that floats. In this case, these countries manifest a "fear of pegging" behavior.

Discrepancies between announced and actual exchange rates may reflect concerns about the political costs of devaluations under an official peg, may result from low credibility of the monetary authority, a trade-off between the cost of intervention of foreign exchange markets and the real output losses caused by exchange rate volatility, a response to the inappropriateness of the official regime to the underlying economic fundamentals, or may reflect the quality of institutions associated with the capability of countries to maintain pegs (Alesina and Wagner 2003, Calvo and Reinhart 2002, Von Hagen and Zhou 2002). Developing countries may not want to let their currencies float freely because their financial markets are less developed, and their central banks fear that a significant devaluation of exchange rate may negatively affect the country's foreign debt and its ability to have access to domestic-currency loans from abroad, which is deemed to be the "original sin" (Eichengreen and Hausmann 1999).[161] A symptom often found in small emerging market economies, where the impact of exchange rate volatility on trade and inflation is considerable, is fear of floating (Calvo and Reinhart 2002).[162]

[161] Developing countries usually have unhedged foreign currency denominated debt and high exchange rate risk exposure and thus have an incentive to peg to the foreign currency that they have borrowed, even if they officially float (Hausmann, Paniza, and Stein 2000).

[162] Some developing and transition countries engage in dollarization, or euroization in Europe, unofficial or official. An unofficial dollarization is the case when a foreign currency is used as a substitute for a domestic currency or prices and wages are set in a foreign currency. The extreme case of official dollarization is when a foreign currency is the only legal tender.

Although the official regime declaration is a signal to currency speculators of the formal commitment of the government and central bank to exchange rate stability, it does not capture the policies inconsistent with this commitment. De facto classification has the advantage of being based on observed behavior. [163] My investigation concerns actual exchange rate policy, so I use the "Natural Exchange Rate Classification" as compiled by Reinhart and Rogoff (2004) (R&R) and extended by Eichengreen and Razo-Garcia (2006) as my primary measure of de facto exchange rate regimes.[164] R&R measure the uses of "parallel" market exchange rates as well as extensive country chronologies of the history of exchange rate arrangements and related factors (such as exchange controls and currency reforms) to determine the actual operation of an exchange rate regime. The R&R classification provides the current state of the art for the measurement of actual exchange rate policies. The R&R measure is more appropriate for my purposes than those of LYS (2005) or Ghosh et al. (1997) because this measure is the most widely available and focuses explicitly on the identification of longer-term "regimes" rather than shorter-term "spells" within a regime (Rogoff et al. 2003: 10).[165]

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[163] Eichengreen and Bayoumi (1996) suggest using the variability of real and nominal exchange rate. In contrast with the *Behavioral* Real Exchange Rate literature (Clark and MacDonald 1998, Eichengreen and Choudry 2005), the goal of this study is not to explain real exchange movements but rather to explain policy choices; thus, it seems less suitable to use measures of the variability of a (nominal or real) exchange rate.

[164] An alternative approach, pioneered by Holden, Holden and Suss (1979), characterizes the de facto exchange rate regime on the basis of the degree of intervention in the foreign exchange market, as measured by variation in international reserves. The problem this approach presents is how to measure the degree of intervention. Using changes in reserves is not satisfactory because the authorities do not necessarily intervene through direct purchases and sales of reserves. It is also difficult to disentangle regime changes associated with intervention from those resulting from exogenous shocks. As a result, only relatively few studies have followed this approach (Poirson 2001: 7).

[165] Ghosh et al. (1997) refine the IMF data on exchange rate regimes from 1973–1996. LYS does not measure exchange rate policies but the ex-post behavior of the exchange rate. LYS developed a de facto classification for 183 countries from 1973–2004 based on the behavior of three variables: changes in nominal exchange rate, the volatility of these changes, and the volatility of foreign reserves. The idea behind LYS is that fixed (flexible) regimes should exhibit low (high) volatility in exchange rate

The R&R classification is based on a 15-point scale. I follow Simmons and Hainmueller (2006) and dichotomize it with a 10-point cutoff.[166] A noticeable feature of the R&R classification is that it distinguishes episodes of high inflation and uncontrolled depreciation as "freely falling" regimes. Contrary to Simmons and Hainmueller, who discard observations classified as "freely falling" (associated with extreme macroeconomic imbalances and inflation higher than 40 percent) and those for which parallel market data are missing, I retain freely falling regimes because they are highly represented in my sample. In the 1990s, freely falling regimes accounted for 41 percent of the observations for the transition economies.

Until recently, the discrepancies between de facto and de jure regimes have largely been ignored in the literature.[167] Most of the existing empirical studies examining the determinants of exchange rate regimes in EE countries use officially announced exchange rate regimes (Kluyev 2002, Von Hagen and Zhou 2002, 2005). Table A.1 in the Appendix presents de facto and the IMF classifications of exchange rate regimes used in this study.

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movements but high (low) volatility in international reserves. LYS data report only 106 observations from 20 transition economies.

[166] The following regimes were coded as fixed: no separate legal tender, pre-announced peg or currency board arrangement, a pre-announced horizontal band with a bandwidth not exceeding +/-2 %, a de facto peg, a pre-announced crawling peg, a pre-announced crawling band with a bandwidth not exceeding +/- 2 %, a de facto crawling peg, a de facto crawling band with a bandwidth not exceeding +/- 2%, and a pre-announced crawling band with a bandwidth exceeding +/- 2 %. A de facto crawling band with a bandwidth not exceeding +/- 5%, a moving band with a bandwidth not exceeding +/- 2%, managed floating, freely floating, freely falling, and hyperfloating were coded as flexible.

[167] Recognizing the substantial divergence between actual and declaratory monetary policy, in 1997, the IMF itself changed its reporting criteria to take into account the actual functioning of a country's regime (Cf. IMF 1999, Section IV and IMF 2003). Another IMF classification of the de facto regimes was recently undertaken by Bubula and Otker-Robe (2002).

Brief Overview of Exchange Rate Regimes in EE[168]

Table 4.1 represents a more systematic presentation of the evolution of exchange rate regimes in EE. Figures 4.1 and 4.2 report the percentages of country observations that fall into two categories of exchange rate regimes—fixed and float—during three sample periods, i.e., 1990–1995, 1995–1999, and 2000–2004, based on the number of country-year observations in each period considered, and comparing de jure with de facto classifications. In figure 4.1, we can observe that the shares of official floats increased from 47.37 percent to 65.85 percent, while the shares of official fixed regimes decreased from 52.63 percent to 34.15 percent over the period 1990–2004. However, the de facto classification reported in figure 4.2 shows that among all EE states, 76 percent actually adopted a floating rate in the early 1990s. This share of actual floats decreased and reached 50 percent at the end of the decade, and subsequently decreased further to 38.66 percent by 2004. In contrast, the share of de facto pegged regimes increased from 23.28 percent in the early 1990s to 61.34 percent in the most recent period.[169] The difference between announced and actual exchange rate policies suggests that EE countries have been more prone to fear of floating than to fear of pegging.

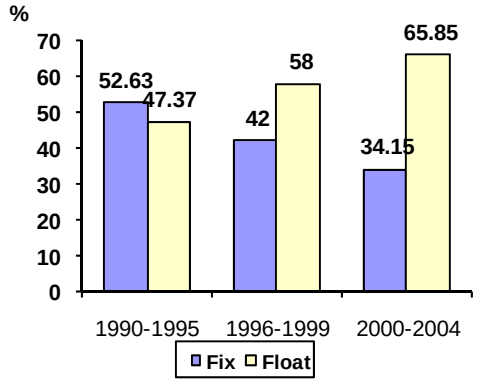
[168] For a detailed history of the evolution of exchange rate regimes in EE, see chapter 5.

[169] R&R make an interesting observation about exchange rate history, claiming that even in the period after Bretton-Woods from 1970–2001, peg and crawling peg were the most popular regimes.

Table 4.1: De jure Exchange Rate Regimes in EE: Intermediate Option (a)

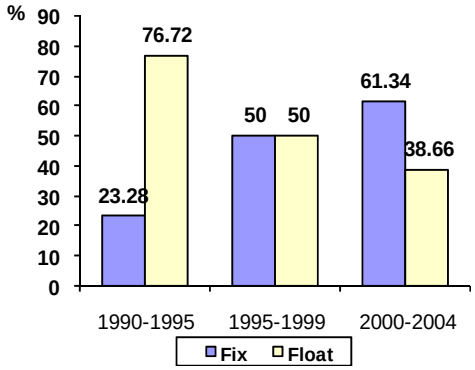
	Hard Peg[1] (%)	*Intermediate[2] (%)*	*Float[3] (%)*
1990–1995	44.74	7.89	47.37
1996–1999	23.00	19.00	58.00
2000–2004	24.39	9.76	65.85

Source: Author's estimates using IMF Annual Report on Exchange Rate Regimes and Restrictions, various issues.
[1]Includes no separate legal tender, currency board, and other conventional fixed pegs.
[2]Includes horizontal bands, crawling pegs, crawling bands.
[3]Includes managed floats and independent floats.



Source: Author's estimates using IMF Annual Report on Exchange Rate Regimes and Restrictions, various issues.

Figure 4.1: De jure exchange rate regimes in EE, 1990–2004



Source: Author's estimates using Reinhart and Rogoff (2004), extended by Razo-Garcia and Eichengreen (2006).

Figure 4.2: De facto exchange rate regimes in EE, 1990–2004

The comparison between de jure and de facto regimes also reveals that intermediate regimes have played in practice a much larger role than according to the official regime classification (tables 4.1 and 4.2). This share has increased over time: from 22.55 percent in the initial years of transition to 46.22 percent during the most recent reported period, so the share of de facto intermediate regimes during the period 2000–2004 was five times as often in place than officially stated. Thus, the bipolar view, reviewed in chapter 1, maintaining that intermediate regimes are not a viable option in a world of high capital mobility cannot be confirmed for the transition economies. Countries with currency boards like Estonia, Bulgaria, Lithuania, and Bosnia and Hercegovina as well as countries that have recently adopted inflation targeting combined with de jure free floats like the Czech Republic and Poland pursue corner solutions. Still, the central banks in the later group of countries continue to intervene in the exchange rate markets.

Table 4.2: De facto Exchange Rate Regimes in EE, 1990–2004: Intermediate Option (b)

	Hard Peg° *(%)*	*Intermediate[1]* *(%)*	*Float[2]* *(%)*	*Freely Falling[3]* *(%)*
1990–1995	6.03	21.55	8.62	63.79
1996–1999	16.67	44.79	11.46	27.08
2000–2004	21.01	46.22	27.73	5.04

Source: Author's estimates using Reinhart and Rogoff (2004), extended by Razo-Garcia and Eichengreen (2006).

°Includes arrangements with no separate legal tender, pre-announced peg or currency boards, and pre-announced horizontal bands with a bandwidth not exceeding +/-2 %.
[1]Includes de facto pegs, pre-announced crawling pegs, pre-announced crawling bands with a bandwidth not [2]exceeding +/-2 %, de facto crawling pegs, de facto crawling bands with a bandwidth not exceeding +/- 2%, pre-announced crawling bands with a bandwidth exceeding +/- 2 %, de facto crawling bands with a bandwidth not exceeding +/– 5%, and moving bands with a bandwidth not exceeding +/– 2%.
[3]Includes managed floats and free floats.

Determinants of Exchange Rate Regime

Primary Variable of Interest: Financial Development

As Frieden (2002) noted, the distributional effects of exchange rate policies are difficult to examine because special interest politics are generally unobservable. It is also difficult to find good proxies for interest group pressures and lobbying. Direct measures of the political power of interest groups and their capability to influence policies are "controversial at best" (Rajan and Zingales 2003: 23). Table A.3 in the Appendix summarizes the proxies for societal interests in recent empirical studies on the political economy of exchange rates.

I argued previously that the influence of banks is mediated by the bank ownership structure, which can be dominated by state-owned, private domestic, or foreign banks. The bank ownership structure, in turn, affects the demand and supply of institutions that supervise and regulate the banking sector and carry out monetary policy. To measure the effect of ownership structure and the institutional quality of the financial system on exchange rate regime choice, I use the three-dimensional index of financial development evolution developed by Fries (2005) based on the annually published EBRD Transition Reports.

The first dimension of this index measures the liberalization and institutional reform of the banking system.[170] The EBRD transition indicator for banking reform evaluates several dimensions of the post-communist reform of the banking sector, including the separation of commercial banking activities from the central bank, liberalization of interest rates and credit allocation, the use of directed credit, progress in the establishment of institutions of prudential regulation and supervision, and the degree of banking competition. The second dimension of the index represents the

[170] The 1998 Transition Report was dedicated to an in-depth examination of banking and financial services in EE.

share of private banks in total bank assets, which indicates the transformation of ownership in banking through the entry of new private banks and the privatization of state banks. The final dimension of the index reports the share of majority foreign-owned banks in total bank assets, which measures the degree of openness to competition from the entry of foreign banks through either the establishment of new banks or the acquisition of existing banks.[171]

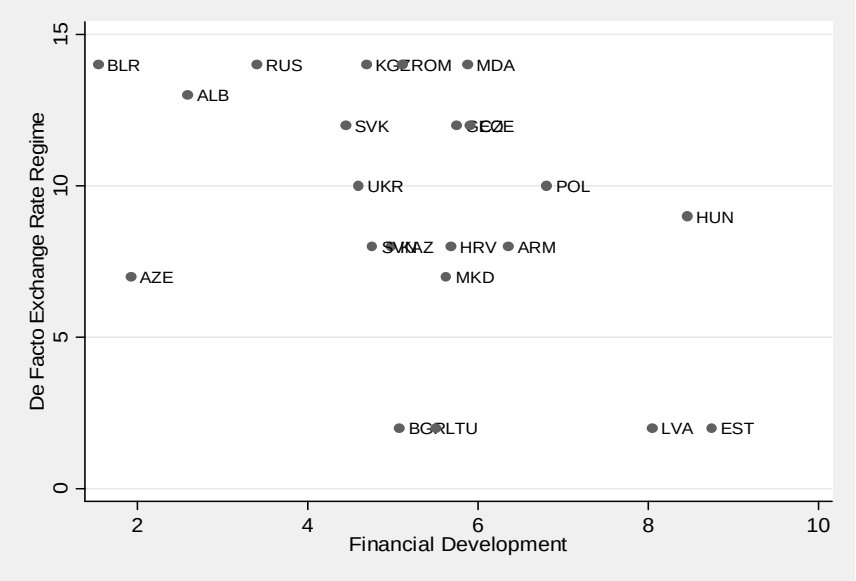
A higher value on this index means a higher share of foreign and private banks in financial intermediation, accompanied by stronger monetary and regulatory institutions, and thus a more developed financial system. With an increase in the level of financial development, I expect a higher probability of adopting and sustaining fixed exchange rate regimes; thus, I expect the sign to be positive.

In figure 4.3, I graph the measure of financial development against the R&R fine classification that includes 15 categories of exchange rate regimes. The graph shows the negative relationship between these two measures: countries at higher levels of financial development have less flexible exchange rates.[172] Figure 4.4 shows four examples of the primary financial development measure for countries. It demonstrates that competitive financial systems, represented by Estonia clearly exhibit a steep upward trend in liberalization of financial institutional-building. As discussed in chapter 3, in contrast with the radical approach to finance reform in Estonia accompanied by a currency board, the Polish approach was more incremental and

[171] I use the index instead of a simple share of foreign bank assets of total banking assets, for it better captures my primary hypothesis. In open financial systems, the presence of foreign banks in financial intermediation is likely to be accompanied by a greater degree of private ownership of banks and banking competition and more developed regulatory and supervisory institutions. The three-dimensional index of financial development variable combining ownership structure with institutional features of the financial system is a better predictor of exchange rate regime policies than its individual dimensions.

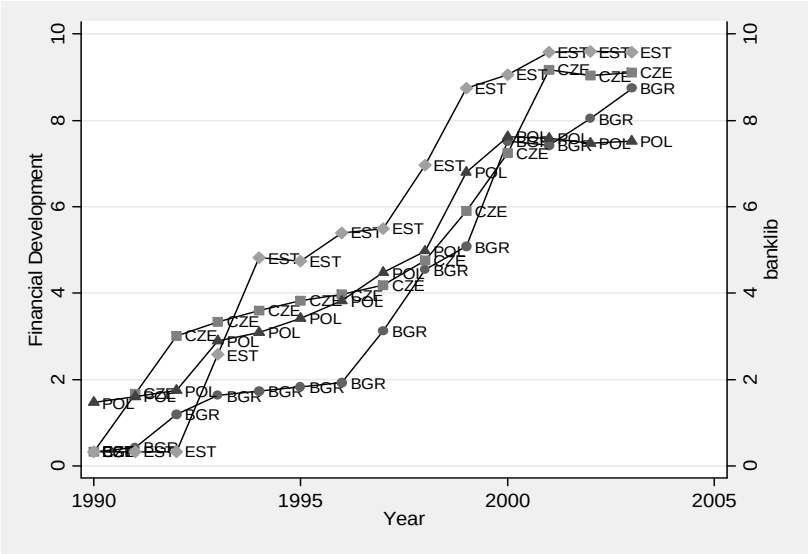
[172] In the R&R fine classification, exchange rate regimes run from 1–15, with 1 representing the most rigid regimes and 15 the most flexible regime. For R&R fine classification of de facto exchange rate regimes, see appendix 1.

shows less dynamic institutional reforms, particularly after 2000 that coincide with the efforts to limit the independence of the central bank and multiple delays in bank privatization. The Czech Republic began the transition with dynamic financial reforms, followed by stagnation until the financial turmoil in 1997, which was the turning point in financial and exchange rate policies. Finally, as the graph shows, Bulgaria as well up to the 1996–1997 financial crisis, did not implement any financial liberalization policies, but it experienced a progressive trend afterwards, accompanied by a hard peg policy.



Source: Author's estimates using IMF Annual Report on Exchange Rate Regimes and Restrictions, various issues.

Figure 4.3: De Facto exchange rate regimes in EE and financial development in 1999



Source: Author's estimates using Reinhart and Rogoff (2004), extended by Razo-Garcia and Eichengreen (2006).

Figure 4.4: Value of financial development for Bulgaria, Estonia, the Czech Republic, and Poland, 1990–2004

Additional Financial Variables

The recent literature has stressed that currency mismatches in financially dollarized economies may be critical to the choice of exchange rate regimes. One important manifestation of the *moral hazard* behavior of domestic incumbent banks is that they borrow excessively abroad at low interest rates and lend excessively at home in domestic currency at high rates, while a close bank-government nexus sets up the expectation that no bank would be allowed to fail (Eichengreen, Hausmann and Paniza 2003).[173] There are two views on the links between exchange rate regime and currency mismatches. On one hand, fixed regimes can encourage currency mismatches because banks and firms do not hedge their foreign liabilities, for they believe that the governmental commitment to defend the peg protects them from exchange rate risk

[173] Eichengreen, Hausmann, and Panizza (2003: 15) identify additional causes of currency mismatches, including insufficient accumulation of reserves as insurance against exchange rate shocks, and the "original sin."

(Mishkin 2006, Obstfeld 1998). Alternatively, greater flexibility increases the cost of hedging and so may not result in lower currency mismatches (Eichengreen and Hausmann 1999).

The literature does not clearly establish the direction of causality. In one view, banks with currency mismatches on their balance sheets may have an interest in maintaining a fixed regime. Therefore, countries with high mismatches may choose to peg (Arteta 2002, Hall 2005, Woodruff 2005). In the second view, when there is a currency mismatch, the government is often unable to maintain the currency value. The central bank has the option of raising interest rates but this can destroy weakened domestic banks that are facing increased funding costs. The outcome is often a banking crisis combined with a currency crisis. Therefore, greater mismatches may force countries to float. I operationalize currency mismatches as the ratio of foreign assets to foreign liabilities in the banking sector. The second view corresponds better to the empirical reality in EE, and thus with higher currency mismatches, I expect a lower probability of sustaining a fixed exchange rate regime.

In developing countries that often exhibit high levels of financial dollarization, it is difficult to disentangle empirically currency mismatches from the impossible trinity considerations. Capital controls should enhance the sustainability of a fixed exchange rate regime, since they make the regime less vulnerable to discrepancies between macroeconomic and exchange rate policies, often leading to capital outflows. To test the influence of capital mobility on exchange rate arrangement, I create a dummy variable, taking the value of 1 for the years when the country accepted the obligations under the Article VIII of the IMF's Articles of Agreement. I expect that

liberalization of capital movements will decrease the sustainability of fixed exchange rates.[174]

The literature examining the role of central bank independence in exchange rate regime choices, discussed in chapter 1, does not clearly establish in which direction central banks should affect an exchange rate regime. Agreeing with Eichengreen and Leblang (2003), I expect that the same factors that led politicians to make their central banks independent would also be positively associated with the decision to limit the monetary autonomy via a fixed exchange rate regime. Thus, I expect that central banks with a higher degree of independence from governments will be less prone to pursue bailouts for banks or to extend massive loans to governments and so generate inflationary pressures that are not compatible with a fixed regime. I use the measure based Cukierman, Miller and Nyeapti (CMN) (2002) indices of central bank independence. CMN developed indices of legal independence for central banks in 26 transition economies in EE for the period 1989–1998. [175] Popova (2000) and Bodea and Popova (2005) followed a similar coding procedure and extended the CMN's database until 2004. Indeed, many EE countries enacted new central bank laws after 1998. For example, Bulgaria enacted a new law on the central bank on July 1, 1997, granting it greater legal independence from the government, but CMN's aggregate index for Bulgaria remains at the same level (0.55) throughout the reported period. The correlation between these two measures of legal central bank independence (CBI) is 0.82.

[174] Many empirical studies use Chinn and Ito's (2004) measure of de jure capital account openness. This measure is based on four binary dummy variables reported in the IMF's Annual Report on Exchange Rates and Exchange Restrictions with a higher number indicating a lower overall level of restrictions. However, data on EE countries are available only for recent years. It reports only the last 5-7 years for a small number of EE countries.

[175] Cukierman, Miller and Neyapti (2002) showed that EE reformers created central banks with levels of legal independence that are higher, on average, than those of developed economies during the 1980s.

Economic Variables

The other two sets of covariates include economic and political variables largely as controls. In order to test the relevance of the traditional OCA hypothesis, I consider two commonly used structural factors that affect regime choice: *openness* and *economic size.* Openness shows the exposure of the country to nominal shocks from the world economy. Greater openness leads to the need for nominal protection, increasing the probability of choosing a fixed regime. Openness also enhances trade gains derived from stable bilateral exchange rates. Countries that depend heavily on international trade with a high proportion of economic agents sensitive to exchange rate risk are expected to favor fixed regimes. Small size affects exchange rate regime choice through its effect on openness, given the higher propensity of small economies to trade internationally. Smaller economies should benefit more from the potential stability provided by a fixed exchange rate. I use real GDP, expressed in logs, to measure the size of a country's economy. I measure a country's dependence on trade with an openness variable composed of imports plus exports as a percentage of GDP.

A large strand of literature has studied the use of fixed exchange rate as a nominal anchor for macroeconomic stabilization in inflationary economies, but the literature does not provide an unambiguous answer. While countries with moderate inflation might have incentives to use the exchange rate as an anchor, high inflation (large but transitory inflation shocks) in a given year makes a fixed exchange rate less sustainable and calls for exchange rate adjustments to align relative prices. High inflation (and hyperinflation) creates pressures on the exchange rate market that may force monetary authorities to devalue and float either voluntarily or as a consequence of a currency crisis (Levy-Yeayti, Sturzenegger and Reggio 2002, Edwards 1996). This phenomenon is in light of a "sustainability hypothesis" that links weak governments with either the collapse of existing pegs or the inability to commit to a

credible peg as a deflationary device. Following Levy-Yeyati, Sturzenegger and Reggio (2002), I include a dummy for *high inflation* (and *hyperinflation)*, defined as an annual inflation rate exceeding 150 percent. I expect high inflation to increase the pressures to float, as the peg becomes unsustainable.

Political Variables

To test Frieden's sectoral hypothesis, I control for the interests of nonfinancial sectors, namely the interests of manufacturing industries and agriculture. Following Frieden, Gheci and Stein (2001), I look at both the agricultural and manufacturing sectors, with the lobbying power of each group assumed to be proportional to that sector's share in the country's GDP. In contrast to these authors and Frieden (2002), who omit non-tradables in their empirical analyses, I follow the standard practice and use the ratio of tradables (industry and agriculture) to nontradables (services), indicating the relative size (as a measure of the economic power) of industrial and agricultural interests. I test whether the manufacturing and agricultural sector might favor greater flexibility (although this might be contingent on the level of protection) and thus focus on the competitiveness of the exchange rate. The higher the value of manufacturing and agriculture in domestic production relative to services and the stronger their "voice," the stronger I expect pressures to be for a more flexible exchange rate regime.[176]

Nondemocracies are alleged to be more likely to adopt fixed rate regimes, although the causal mechanism behind this correlation is debated, as chapter 1 illustrates. I expect that as democracy consolidates, the likelihood of pursuing fixed

[176] I am aware that these proxies do not cover all private interests, especially foreign investors in the real sector. Because the impact of FDIs in industrial sectors is not central to my theory, I do not control for it in my empirical model.

exchange rate regimes decreases. I use the Freedom House scores as a proxy for the level of democratic consolidation.[177]

Empirical Model: Probability of Fixing

In this section, I present the econometric model applied to test the hypotheses presented in the previous section in a unified framework. I use binary logit on panel data as my baseline econometric model of exchange rate regime choice.[178] Logit analysis allows time-varying determinants, so it is a useful tool for estimating the annual probability of an exchange rate peg (Klein and Marion 1997).[179]

I describe the choices of exchange rate regimes using a discrete variable, $y_{i,t}$. This variable can take one of two values:

$y_{i,t} = 0$ if the country i chooses a flexible regime in year t,

$y_{i,t} = 1$ if the country i chooses a fixed exchange rate regime in year t

with the probabilities p_i, where $i = 0, 1$ and $\sum p_i = 1$.

[177] The Polity 2 variable drawn from the POLITY IV database is the most popular measure of the level of democratization in a state. However, Polity 2 during years that were affected by interruptions, interregnum, and transitions seem to produce distorted and misleading information about the true level of democracy (Pluemper and Neumayer 2007) and does not correspond to the empirical reality in EE states. For no clear reason, Polity 2 measures reports for Estonia, the leader of transition, the unchanged score 6 from the beginning of transition, while the scores of laggards in democratization such as Moldova or Romania are assigned scores of 8 and 9, for 2004. It is equally unclear why the project reports the highest democracy score of 10 for Hungary from the outset of the transition.

[178] Besides rare analyses based on OLS (Holden, Holden, and Suss 1979), most studies on exchange rate regime choice have used discrete choice models (binary or ordered logit and probit). See, for example: Collins (1996) Poirson (2001), Klein and Marion (1997), Hallerberg (2002), Broz (2002), Schamis and Way (2003), Shambaugh (2004), von Hagen and Zhou (2005), and others. For studies examining the collapse of fixed exchange rate regimes, see Frankel and Rose (1996), Sachs, Tornell, and Velasco (1996), Kaminsky, Lizondo, and Reinhart (1998).

[179] Although there are similarities between binary choice and survival models, logistic regressions with a binary dependent variable are more appropriate for my analysis because some of the cases switched from pegs to floats and back to pegs. Hazard models are designed to model the transition from one state to another state instead (Author's conversation with Christoper Zorn and David Freedman, August 2006). For an excellent treatment of logistic regressions, see Long (1997).

I estimate the following panel data random effects logit for fixed regimes:[180]

$$\Pr(y_{it} = 1 \mid x_{it}, c_i) = \exp(x_{it} + c_i) / 1 + \exp(x_{it} + c_i) \ .$$

This choice is based on the continuous latent variable $y^*_{i,t}$ (attractiveness of the fixed exchange rate regime), which is a linear function of all the variables:

$$y^*_{it} = x_{it}\beta + \upsilon_{it}, y_{it} = 1\{y^*_{it} > 0\}$$

where $y_{it} = 1$ if country i chooses a fixed exchange rate regime in year t, and the composite error $\upsilon_{it} = c_i + u_{it}$ is such that both the unobserved effect c_i and the idiosyncratic error u_{it} are orthogonal to x_{it}. Vector x_{it} is a vector of explanatory variables and includes three sets of covariates: financial, economic, and political.

The likelihood of belonging to these categories is defined in terms of probabilities of the values of an underlying latent variable, $y^*_{i,t}$. I can assume here that the error terms follow the logistic or normal distribution. Because probit estimations provide similar results, my arbitrary choice of logistic distribution has no negative consequences for the quality of this study. Therefore, I estimate binary logit random effects models on all country-year observations.[181] All data are annual, and the independent variables are lagged one year.

The econometric literature on panel data models suggests employing the specific fixed effects model if the empirical model focuses on a particular set of

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[180] Random effects models use the information from both cross-country and within-country variation. These models fully utilize the panel information: they use country-pair fixed-effects, while allowing for time invariant regressors. Random effect estimates are usually more efficient because they use information both "between" and "within" panels. Panel data random effects models however, impose more stringent assumptions on the structure of the errors than a fixed effects formulation: $E(u_{it} \mid x_{i,} u_i) = 0, t = 1,..., T$ and $E(x_i \mid u_i) = E(u_i) = 0, x_i = (x_{i1}, x_{i2},..., x_{iT})$.

[181] I should test for the *poolability* of our data in order to compare the panel data model to the cross-sectional model. The standard procedure in this case is the likelihood ratio test for two models: the large one with estimated country-specific effects and the nested one without these effects. However, because the ML is an inconsistent estimator of the first one, the likelihood ratio test fails ex ante. For a good examination of panel data, see Wooldridge (2002) and Hsiao (2003).

countries. However, the maximum likelihood estimator (MLE) is inconsistent in the case of a country-specific fixed effects model (Chamberlain 1980). As N tends to infinity, for a fixed T, the number of fixed effects μ_i, *for* $I = 1, \ldots, N$, increases with the sample size N, and we have an incidental-parameters problem (Wooldridge 2002). This means that fixed effects cannot be consistently estimated for a fixed T. Although MLE is consistent when T tends to infinity, T is usually small for panel data (T=12–15 in my case).[182] For the linear panel data regression model, when T is fixed, only parameters of explanatory variables β can be estimated consistently, by removing the fixed effects from the estimated model. This is possible for the linear case because the MLE of β and μ_i are asymptomatically independent, but this is no longer the case for a qualitative limited dependent variable model with fixed *T.* With country-specific effects, MLE does not provide consistent estimates for the coefficients.

Another potential problem is omitted variable bias; that is, variables that would explain the choice of exchange rate regimes but whose effects, because they are not included as explanations, are incorrectly attributed to the included variables. The introduction of country-specific fixed effects into the regression can control for (country-specific) omitted variables that may be correlated with the right-hand-side variables, but this method has some drawbacks. By restricting information to within-country variability, the usefulness of the data is drastically reduced, and important information is thrown out. As long as we are interested in the long-run determinants of regime choices, it is advisable to preserve the cross-country comparison of time-invariant pegs and floats, i.e., between-country variability. A key drawback of fixed effect estimators is that if time-invariant regressors are included in the model, the standard fixed effects estimator will not produce estimates for the effects of these

[182] Because the classifications of exchange rate regimes used in this study cover different periods, *T* varies from 12–15 depending on the classification used.

variables. Fixed effects do not eliminate time-variant omitted variables that may still result in biased estimates. As Levy-Yeyati et al. (2002: 13–14) argue, "With fixed effects, this cross-country result is lost, as the logit estimation uses the fixed effect to match the probability of the observed outcome for that country regardless of the coefficients on the other variables, thus dumping all variables without within-country volatility and all data for countries for which the chosen regime does not change." When there is no compelling choice between the two models, the random-effects model is often preferred if there are covariates that are constant within panels. Fixed-effects models are not able to estimate the coefficients of these theoretically interesting time-invariant covariates because the covariate is collinear with the fixed effect (Hardin and Hilbe 2000: 34, Wooldridge 2002). I choose to use random effects also because I include some (institutional) time-invariant covariates in $x_{i.}$.[183]

Another econometric issue associated with this analysis concerns inconsistency between the de jure and de facto natures of exchange rate regimes. As shown above, widespread and serious discrepancies between official and actual regimes have been observed in EE. Relying only on official announcements could be misleading. Therefore, I use the R&R (2004) de facto measure, extended by Razo-Garcia (2006), as my primary measure of exchange rate regimes. For robustness checks, I also employ the IMF de jure classification of exchange rates.

Finally, temporal dependencies in the choices of exchange rate arrangements are likely to play an important role, for past experiences with a certain regime can influence its desirability and the probability of its continuity. Controlling for the "stickiness" of a regime in regressions is usually done by including a lagged value of

[183] Acemoglu et al. (2002: 27 and 2003) justify not accounting for unit effects in the following way: "Recall that our interest in the historically-determined component of institutions (that is more clearly exogenous), hence not in the variations in institutions from year-to-year. As a result, this regression does not (cannot) control for a full set of country dummies."

the dependent variable as a regressor—what Beck et al. (2002) call the "restricted transition model"—or allowing for serial correlation in the error term. In my case, the only justification for including a lagged *y* in logistic regressions would be to assume that a fix (float) at *t–1* itself causes the fix (float) in the current period. This is different from the standard time-series assumption that the underlying latent *y*,* i.e., latent propensity to peg, shows persistence over time. However, the presence of a lagged dependent variable precludes the use of standard fixed or random effects estimators. Fixed and random effects rely on a strong exogeneity assumption that is automatically violated in dynamic panels (Keane and Runkle 1992).[184] Thus, I do not estimate a dynamic panel of regime choice.

In conjunction with using the random effects binary logit models on panel data, I pursue two additional econometric modeling strategies. I estimate a multinomial logit model with an unordered dependent variable using four categories of exchange rate regimes in R&R classification. Second, I also estimate a random effects model using R&R fine grid classification with 15 categories of exchange rates to measure the exchange rate regime's rigidity.

Discussion of Empirical Results

Table 4.3 reports descriptive statistics for the principal variables used in the empirical model of exchange rate determination. Data availability constraints on some covariates reduce the sample size. The use of lagged variables further restricts the sample. Table 4.3 presents a correlation matrix that demonstrates that there are very few correlations of note among the principal explanatory variables. This is of particular importance because it would be reasonable to worry about the collinearity.

[184] See, also: Beck, Katz, and Tucker (1998).

Table 4.4 reports my estimates from a baseline specification of the model including the principal financial variables, as well as economic and political controls. A positive sign associated with a variable means that a larger value raises the probability for a choice and sustainability of a fixed exchange rate regime. All regressions include lagged values of all explanatory variables. The main and most consistent result of the baseline *static* models is that financial variables play a significant role in choosing and sustaining a de facto exchange rate regime in EE countries. Column (1) presents a basic version of the model that tests the impact of my principal variable financial development on exchange rate. Column (2) includes other financial variables and economic control variables. Column (3) evaluates and controls for political effects. Column (4) is a benchmark model that includes financial, economic and political covariates.

Table 4.3: Summary Statistics

This table provides summary statistics for the principal variables used in the paper. For each variable, the number of observations, the mean, standard deviation, minimum value, maximum values are reported.

Variable	*Obs*	*Mean*	*Std. Dev.*	*Min*	*Max*
Exchange Rate Regime	331	0.447	0.498	0	1
Financial Development	308	3.975	2.633	0.33	9.59
Currency Mismatch	285	1.756	6.240	0	72.060
Central Bank Independence	243	0.556	0.180	0.178	0.875
Non-Financial Sectors	362	1.325	0.867	0.2902871	5.290
Democratic Consolidation	354	7.059	3.484	2	14
High Inflation	356	0.205	0.404	0	1
Openness	353	94.785	33.131	26.257	182.673
Size	375	3.82e+10	8.24e+10	7.09e+08	5.82e+11
Capital Liberalization	375	0.477	0.500	0	1

The coefficient estimates of all financial variables—financial development, central bank independence, and currency mismatches—are statistically significant and have the expected sign in all regressions. Countries with financially developed systems dominated by foreign and private banks and characterized by strong monetary and regulatory institutions tend to adopt and sustain more rigid exchange rate regimes. This interpretation is supported by the positive coefficient for the first two financial variables. Conversely, a higher level of mismatches on bank balance sheets makes it more difficult to sustain a currency peg.

The macroeconomic fundamentals considered by OCA theory also provide some guidance in the choice of exchange rate regimes. The negative sign on the high inflation dummy coefficient indicates that at very high and unmanageable levels of inflation (higher than 150 percent in this model), inflation is considered to be the most important problem in an economy. High inflation as a result of expansionary monetary policy leads to the collapse of a fixed exchange rate regime. The sign of the GDP coefficient estimate suggests that larger countries are less likely to peg, although its effect becomes insignificant when political variables are included in the model.

Contrary to conventional expectations, degree of openness has a negative sign, for an increase in the openness of an economy decreases the probability of choosing a fixed regime.[185] This is quite intuitive because open economies are more vulnerable to external shocks. The mean value of openness of all EE countries is 94.8 percent. To moderate the negative impact of foreign shocks, EE governments pursue flexible exchange rates.[186] In line with the "impossible trinity hypothesis," the coefficient of

[185] Internationally oriented economic agents might prefer a flexible arrangement to allow depreciation, thus maintaining the competitiveness of major trading partners, which suggests that small and open economies might be averse to fixed rates.

[186] Poirson (2001) and Kato and Uctum (2003) also find that developing countries prefer to keep flexible or intermediate regimes.

the liberalization of capital movements shows that as countries liberalize capital accounts, they tend to move toward more flexible regimes, but this influence does not attain statistical significance.

Turning to political variables, regime choice is influenced by both degree of democratic consolidation and nonfinancial sectors. The positive sign on the democracy coefficient indicates that governments in those EE countries that attained a higher degree of democratic consolidation faced more intense distributional pressures from interest groups and were thus less likely to sustain a currency peg.[187] A higher proportion of domestic producers in manufacturing and agriculture relative to services also makes it more difficult to choose a fixed regime.

Interpreting the estimated coefficients is difficult because the effect of a change in an explanatory variable on the likelihood of choosing a particular regime depends on the value of the coefficient and on the realization of the explanatory variable itself. To facilitate interpretation, column (5) in table 4.5 reports the marginal effects of a change in each explanatory variable on the probability of choosing an exchange rate peg. Marginal effects are measured by the first-order partial derivatives of the probabilities with respect to the variable in question and evaluated at the sample mean of each variable. The marginal effects of the dummy variables are measured as changes in the relevant probability when the dummy switches from 0 to 1.

[187] Freedom House Democracy scores on political rights and civil liberties run from 1–14, with 1 representing the highest level of democracy and 14 the lowest. Therefore, we have to reverse the interpretation of the coefficients of our logit estimation.

Table 4.4: Correlation Table

The table reports correlation among principal variables.

	Exchange Rate Regime	*Financial Development*	*Currency Mismatch*	*Central Bank Indepen-dence*	*Non-Financial Sectors*	*Democracy*	*High Inflation*	*Openness*	*Size*	*Capital Liberalization*
Exchange Rate Regime	1.0000									
Financial Development	0.4576	1.0000								
Currency Mismatch	–0.0034	–0.0367	1.0000							
Central Bank Independence	0.1382	0.4211	–0.0031	1.0000						
Non–Financial Sectors	–0.2721	–0.4174	–0.0502	–0.3004	1.0000					
Democracy	–0.1345	–0.4315	–0.0758	–0.3813	0.4512	1.0000				
High Inflation	–0.3774	–0.4756	0.0387	–0.3320	0.4387	0.2772	1.0000			
Openness	0.2767	0.3043	0.0143	0.1971	–0.1483	–0.2185	0.0013	1.0000		
Size	–0.1938	–0.0986	–0.0615	–0.0363	–0.1637	–0.0439	0.0768	–0.3552	1.0000	
Capital Liberalization	0.3726	0.6946	–0.0438	0.3901	–0.3964	–0.2842	–0.5411	0.1964	0.0601	1.0000

The set of regressions presented in table 4.5 offers solid evidence that the level of financial development (private and foreign ownership and the quality of supervisory and regulatory institutions) plays an important role in exchange rate regime choices. It is also reassuring that other financial variables in the regressions have the expected effects: central bank independence has a positive and significant impact on the probability of fixing while the effect of currency mismatches is negative and statistically significant.

Robustness Checks

In the next subsection, I discuss further evidence on the robustness of my main empirical findings. I examine whether the results are robust to alternative exchange rate classifications, additional control variables, and alternative estimation methods. The main results corresponding to this discussion are presented in tables 4.6–4.11.

Alternative Model Specifications

Financial variables appear to be persistent. To control for persistence effects, I ran several variations on the above model to check the robustness of my results and to consider some extensions of my argument, and the main results remain stable.[188] I use the following:

- Financial crises

A typical scenario of a financial crisis is a period of fixed regime, followed by a large devaluation and collapse of peg. Many countries in EE were affected by the 1998 Russian financial crises. I control for the contagion effect of the Russian crisis by introducing a crisis dummy in table 4.6, column (1). I show that this does not significantly affect my results.

[188] In addition to robustness checks reported here, I also used added the measure of the IMF influence proxied by a country's participation in IMF programs and a control for foreign exchange reserves. In general, these sensitivity tests did not significantly change the main results.

Table 4.5: Determinants of De Facto Exchange Rate Regimes

Dependent Variable: Probability of Pursuing a Fixed Regime with the Reinhart and Rogoff (2004) De Facto Exchange Rate Regime Classification, extended by Eichengreen and Razo-Garcia (2006).
Estimation: Random Effects Logit Model.

	(1) Primary Variable	*(2) Financial and Economic Covariates*	*(3) Financial and Political Covariates*	*(4) Financial, Economic and Political Covariates*	*(5) Marginal Effects Based on specification (4)*
Financial Development	0.562***	0.512**	0.500***	0.513*	0.127
	(0.138)	(0.190)	(0.144)	(0.200)	
Central Bank Independence		6.872**	8.355**	4.947*	1.222
		(2.627)	(2.549)	(1.984)	
Currency Mismatch (log)		–0.719*	–0.557*	–0.817**	–0.202
		(0.286)	(0.249)	(0.277)	
High Inflation		–2.358**		–2.261**	–0.485
		(0.891)		(0.860)	
Openness		–0.031 *		–0.004	–0.001
		(0.012)		(0.010)	
Capital Liberalization		–0.159		–0.525	–0.128
		(0.733)		(0.746)	
Size (log)		–0.641***		–0.983***	–0.243
		(0.191)		(0.267)	
Non–Financial Sectors (log)			–3.007***	–3.005**	–0.742
			(0.817)	(1.059)	
Democracy			0.825***	0.407***	0.101
			(0.152)	(0.120)	
Constant	–5.409***	11.367**	–11.387***	16.024*	
	(1.314)	(4.713)	(2.262)	(6.548)	
Log Likelihood	–139.468	–88.285	–85.496	–81.077	
Prob > chi2	0.000	0.000	0.000	0.000	
Observations	300	229	229	229	

Note: Statistics with *, **, *** are significant at 10%, 5%, and 1% levels.
Standard errors are in parentheses.

- European Union (EU)

I control for EU influence by using a dummy variable for the preparation for EU accession.[189] The EU dummy could be also treated as a regional dummy or as a control for the level of economic development because the countries involved in the

[189] I re-estimate the model (but do not report), employing the distance from Brussels as an alternative measure of the EU influence.

EU integration process are also the leaders in economic reforms. I report in table 4.6, column (2) that the EU does not appear to have a significant impact on exchange rate regime choice, but the main result of regressions remains stable and significant.[190]

- Government Partisanship

Scholars also examined political parties that mediate interest group preferences for exchange rates (Bearce 2003). Some have argued that right wing parties are likely to support fixed regimes because their business constituencies benefit from low inflation and stable currency made possible by fixing (Simmons 1994). Left wing parties, reflecting the working class interests, are less concerned with controlling inflation (Garrett 1995, Simmons 1994, Leblang 2003). Still, tests on the partisan arguments on the choice of exchange rate regimes have produced only mixed results. I tested for the effect of party polarization on exchange rate regime, and as table 4.6, column (3) shows, it does not significantly affect exchange rate regime choice. Nor does the inclusion of a political-party variable change the coefficient estimates on the principal explanatory variables. This result is in line with the predominant view in the literature on political parties in EE, according to which the ideological dimensions of party systems in EE are less important than their socio-cultural dimensions and their attitudes toward the communist regime. The party labels of EE governmental incumbents do not always reveal their true economic policy stance (Kitschelt et al. 1999). In addition, transposing the sector-group perspective into partisan politics is not easy because many economic sectors cut across traditional party lines (Frieden 1991). In sum, for the domain of transition economies as a whole, arguments stressing party politics alone have little relevance for explaining currency politics.

[190] This result might be explained by the fact that there is a high correlation between democracy levels and EU integration. EE countries that are associated/member countries of the EU are also more democratic, since democratic consolidation is a precondition of EU membership (the correlation coefficient is 0.73). I am thankful to Grigor Stoevsky, Economic Research and Projections Directorate, Bulgarian National Bank for this comment.

Table 4.6: Determinants of De Facto Exchange Rate Regimes

Robustness: Alternative Model Specifications.
Probability of Pursuing a Fixed Regime with the Reinhart and Rogoff (2004) De Facto Exchange Rate Regime Classification, extended by Eichengreen and Razo–Garcia (2006).
Estimation: Random Effects Logit Model.

	(1) Financial Crisis	*(2) European Union*	*(3) Party Ideology*
Financial Development	0.507*	0.488*	0.528**
	(0.199)	(0.198)	(0.204)
Central Bank	5.065*	5.109*	4.678*
Independence	(1.993)	(2.058)	(1.991)
Currency Mismatch (log)	–0.812**	–0.759**	–0.857**
	(0.273)	(0.288)	(0.281)
High Inflation	–2.299**	–2.115*	–2.240**
	(0.853)	(0.883)	(0.866)
Openness	–0.004	–0.007	–0.006
	(0.010)	(0.011)	(0.010)
Capital Liberalization	–0.474	–0.370	–0.530
	(0.751)	(0.749)	(0.757)
Size (log)	–0.972***	–0.983***	–0.959***
	(0.269)	(0.268)	(0.269)
Nonfinancial Sectors (log)	–2.924**	–2.653*	–2.972**
	(1.054)	(1.069)	(1.062)
Democracy	0.408***	0.487***	0.435***
	(0.120)	(0.138)	(0.126)
Financial Crisis	–0.762		
	(0.817)		
European Union		1.028	
		(0.860)	
Party Ideology			0.542
			(0.631)
Constant	15.769*	15.321*	15.290*
	6.571	(6.540)	(6.603)
Log Likelihood	–80.637	–80.350	–80.707
Prob > chi2	0.000	0.000	0.000
Observations	229	229	229

Note: Statistics with *, **, *** are significant at 10%, 5%, and 1% levels.
Standard errors are in parentheses.

Alternative Measures

In addition to my primary measure of financial development, I also use change in the ratio of credit to private sector to GDP that is frequently used in empirical studies. This measure accounts for one of the most important functions of the financial sector: channeling savings to the productive sectors of the economy (King and Levine 2000). Nonetheless, it does not capture the main hypotheses advanced in this study. In EE, the easier access of enterprises to finance was not necessarily reflected in increased bank lending to the private sector, for two reasons: first, the privatization of state-owned enterprises led to a significant increase in private credit to GDP, even in the absence of privatization and development in the financial sector; and second, reform of the socialist system of finance was aimed at both reducing the scale of bad credit and creating new institutions and sound credit policies. Therefore, the outcome was better loan quality rather than simply a credit increase. The interest rate spreads, that is, spreads between bank lending and deposit interest rates, measuring the financial terms on which borrowing enterprises can access funds that my index of financial development evaluates, better reflect an improvement in access to finance by enterprises (Fries 2005).

In addition to the ratio of credit issued to private firms to GDP, I also use the measure of the importance of commercial banks relative to the central bank in allocating domestic credit (the ratio of deposit money bank domestic assets to deposit money bank domestic assets plus central bank domestic assets) as alternate measures of financial development, following King and Levine (2000). This measure accounts for the degree to which commercial banks or the central bank allocate society's savings. The expectation is that private commercial banks are better able to identify profitable investments and monitor managers and facilitate resource mobilization than central banks (Beck, Levine and Loyaza 2000: 268). (In addition to these three

indicators of financial ownership and institutional development, I also consider directed credit as additional measure in the sensitivity section.)[191]

Table 4.7, columns (1) and (2), present results when alternate measures of financial development are used. When the importance of banks relative to the central bank in allocating domestic credit is used to measure financial development (column 1), I obtain results substantively and statistically similar to those in the baseline model. Column (2) shows that when private credit to GDP to measure financial development as a robustness check is used, this alternative measure of financial development does not enter with a coefficient that differs significantly from zero at conventional confidence levels. Nevertheless, my main results remain stable and significant. Only the coefficient for trade openness became positive and statistically significant: open economies are more likely to fix. A potential explanation is that not only does this measure not capture the principal hypothesis examined in this study, but it also excludes credits issued by the central bank and development banks, as well as credit to the public sector and claims of one group of financial intermediaries on another (Beck et al. 2000). This is a serious deficiency for this measure because many EE central banks extended massive credits to their governments and to the state enterprise and financial sectors.

[191] Liquid liabilities of the financial system divided by GDP is also used as a measure of financial sector development. However, this is a measure of financial depth; that is, the overall size of the financial sector, so it does not gauge the influence of different types of financial interests and institutions, which are the primary focus of this analysis.

Table 4.7: Determinants of De Facto Exchange Rate Regimes

Robustness: Alternative Measures of Selected Explanatory Variables.
Probability of Pursuing a Fixed Regime with the Reinhart and Rogoff (2004) De Facto Exchange Rate Regime Classification, extended by Eichengreen and Razo-Garcia (2006).
Estimation: Random Effects Logit Model.

	(1) Alternative measure of financial development (1)	*(2) Alternative measure of financial development (2)*	*(3) Alternative measure of democracy*
Financial Development	7.851**	–0.584	0.373*
	(2.483)	(0.788)	(0.181)
Central Bank Independence	7.258**	10.091*	4.839 *
	(2.797)	(4.481)	(2.008)
Currency Mismatch (log)	–1.336***	–0.939*	–0.820 **
	(0.351)	(0.444)	(0.264)
High Inflation	–3.355**	–4.879*	–2.261**
	(1.107)	(2.301)	(0.850)
Openness	–0.026	0.062*	–0.003
	(0.014)	(0.029)	0.010
Capital Liberalization	0.686	–1.870	–0.167
	(0.633)	(1.419)	(0.725)
Size (log)	–1.838***	–0.599	–1.010
	(0.433)	(0.439)	***
			(0.253)
Non–Financial Sectors (log)	–5.591***	–5.132**	–2.462*
	(1.443)	(1.673)	(0.958)
Democracy	1.021***	1.065**	–0.444 *
	(0.225)	(0.349)	(0.175)
Constant	27.869***	–4.241	22.119***
	(8.175)	(12.555)	(6.319)
Log Likelihood	–78.724	–51.908	–84.117
Prob > chi2	0.000	0.009	0.000
Observations	225	175	229

Note: Statistics with *, **, *** are significant at 10%, 5%, and 1% levels. Standard errors are in parentheses.

Finally, following Acemoglu et al. (2003), I also use constraints placed on executives and dictators as an alternative measure of democracy. This measure refers to the extent of institutionalized constraints on the decision-making powers of chief executives, whether individuals or collectivities, so the focus is on the checks and balances between the various parts of the decision-making process. Higher scores are related to more veto points in the institutional structure. Table 4.7, column (3), shows that the results remain the same: democracies are more likely to float their currencies than autocracies.[192]

Alternative Exchange Rate Regime Classifications

I re-estimated my model using the IMF de jure regime classification to test whether the difference in exchange rate strategies among EE countries can be explained by the inappropriateness of the different classifications.[193] There are indeed observable differences between the results of the models based on the de facto and the de jure regime specifications. These differences are not surprising given that the observed discrepancies between the two classifications are well documented. The correlation between these two regime classifications is low (the correlation coefficient is 0.29). As I illustrate in chapter 5 and the case study chapters, governments in many EE states officially proclaimed fixed regimes but due to the institutional weaknesses of their national financial systems, they were incapable, in practice, of sustaining pegs, and they reneged on their declared regimes and devalued currencies. On the other

[192] Following Levy-Yeyati, Sturzenegger and Regio (2007), I also use the ratio of foreign liabilities in the domestic financial sector relative to money stocks to measure liability dollarization as an alternative proxy for the presence of currency mismatches. I also use the Cukierman, Miller and Neyapti (2002) index of central bank independence. While coefficients on both CBI and currency mismatches become insignificant, the coefficient on the primary financial variable remains stable and statistically significant. The results are available from the author on request.

[193] Using the IMF classification, the following regimes were coded as fixed: dollarization, euroization, currency boards, conventional fixed pegs, horizontal bands, crawling pegs, and crawling bands. Managed floats with no pre-announced path for the exchange rate and independent float were coded as floats.

hand, actual exchange rate arrangements in countries with institutionally advanced financial systems dominated by foreign financiers resemble fixed regimes although the monetary authorities officially declared flexible regimes. Hence, I argue that de facto categories are preferable descriptions of exchange rate policies in EE.

As can be seen in table 4.8 (columns 1 and 2), the financial development coefficient estimate remains statistically significant, but it does not have the expected sign. The coefficient on central bank independence shifted in the opposite direction and became insignificant. With regard to financial determinants, only the coefficient on currency mismatches enters with the same sign and significance. Democracy remains statistically significant, but now autocracies prefer more flexibility in their exchange policies. The coefficient on nonfinancial sectors remains stable and significant in the expected direction. Turning to economic determinants, none has attained statistical significance. These results suggest that official regime choices seem to be less guided by macroeconomic fundamentals than de facto regimes.[194]

A country that chooses a fixed regime must have sufficient international reserves to assure its credibility and sustainability. The collapse of a fixed regime is often associated with the steady erosion of international reserves. The availability of foreign exchange reserves to defend a currency peg is important to reduce the risk of speculative attacks, so I introduce international reserves in months of imports to control for this effect (table 4.8, column 3). I use the IMF classification of exchange rate regime to test this effect because it is the official regime declarations that signal to the financial markets and to speculators the commitment and ability of central banks to sustaining a currency peg. Nonetheless, the level of foreign exchange reserves does not play a significant role in regime choices if de jure classification is used.

[194] Zhou and Von Hagen (2004) use a simultaneous equation model to explain the joint determination of the two regimes because the distributions of de facto and de jure exchange rate regimes are not independent of each other.

Table 4.8: Determinants of De Jure Exchange Rate Regimes

Robustness: Alternative Exchange Rate Regime Classifications.
Probability of Pursuing a Fixed Regime with the IMF De Jure Exchange Rate Regime Classification.
Estimation: Random Effects Logit Model.

	(1)	*(2)*	*(3) Controlling for foreign reserves*	*Marginal Effects based on Model (2)*
Financial Development	–0.363 *	–0.481*	–0.676**	–0.0784
	(0.166)	(0.188)	(0.218)	
Central Bank Independence	–0.899	–0.292	–2.700	–0.0476
	(1.351)	(1.383)	(1.551)	
Currency Mismatch (log)	–0.532 *	–0.519 *	–1.188**	–.0846
	(0.255)	(0.239)	(0.378)	
High Inflation	–0.812	–0.442	–0.053	–0.066
	(0.722)	(0.756)	(0.904)	
Openness	0.029 **	0.017	0.006	0.0028
	(0.010)	(0.011)	(0.010)	
Capital Liberalization	0.289	0.0757	–0.033	0.0123
	(0.726)	(0.705)	(0.791)	
Size (log)	0.755**	–0.100	–0.474	–0.0163
	(0.239)	(0.247)	(0.285)	
Non–Financial Sectors (log)		–2.737*	–4.348**	–0.446
		(1.167)	(1.406)	
Democracy		–0.359 **	–0.170	–0.0585
		(0.119)	(0.110)	
Reserves			0.809	
			(0.487)	
Constant	–19.493	3.542	0.809	
	(6.057)	(6.772)	(0.487)	
Log Likelihood	–97.074	–96.149	–85.412	
Prob > chi2	0.02	0.020	0.01	
Observations	228	228	214	

Note: Statistics with *, **, *** are significant at 10%, 5%, and 1% level, respectively. Standard errors are in parentheses.

Alternative Estimation Methods

Exchange rate regimes adopted by EE countries cover a wide range of alternatives, some of which do not fall neatly into the conventional fixed-flexible dichotomy, so it is useful to examine the results with unordered choice between different categories of exchange rate regimes. I adopt a multivariate model with an unordered polychotomous dependent variable using cross-country pooled data. Following Eichengreen and Razo Garcia (2006), this model allows four choices of de facto regimes: hard peg, intermediate, float, and freely falling regimes. As table 4.9 shows, I choose different regime outcomes as the base categories: hard pegs (columns 1–3), and freely falling (columns 4–5). Consistent with my predictions, countries with more developed financial systems tend to choose fixed regimes (hard pegs and intermediate) over freely falling regimes. The probability of choosing hard pegs also increases as central bank independence increases.

Nevertheless, the results change when I choose freely falling regimes as the base category: a higher degree of central bank independence increases the probability of choosing freely falling regimes over intermediate regimes and floats. This is quite intuitive: freely falling regimes are usually associated with very high levels of inflation, followed by a currency crisis. High inflation puts pressure on a fixed regime. A central bank tries to defend the currency by selling its foreign reserves. A steady erosion of international reserves leads to the collapse of a fixed exchange rate regime. Finally, as expected, countries with currency mismatches tend to prefer more flexible regimes. Figure 4.5 shows that predicted probabilities for the extreme categories as well as for floats tend to be less than 0.25, with most predictions for intermediate regimes falling between 0 and 0.75.

Table 4.9: Determinants of De Facto Exchange Rate Regimes

Robustness: Alternative Estimation Methods—Multinomial Logit Model.
Probability of Pursuing a Fixed Regime with the Reinhart and Rogoff (2004) De Facto Exchange Rate Regime Classification.

	(1) Interme-diate-Hard peg	*(2) Floating-Hard peg*	*(3) Freely falling-Hard peg*	*(4) Interme-diate-Freely falling*	*(5) Floating-Freely falling*
Financial Development	0.243 (0.173)	0.162 (0.194)	–0.620* (0.252)	0.863*** (0.213)	0.782*** (0.235)
Central Bank Independence	–7.613*** (2.132)	–4.514* (2.285)	–3.743 (2.379)	–3.870** (1.441)	–0.772 (1.771)
Currency Mismatch (log)	0.926** (0.343)	0.172 (0.344)	0.964** (0.347)	–0.038 (0.226)	–0.792*** (0.240)
High Inflation	–2.693 (1.420)	–0.694 (1.438)	–0.942 (1.370)	–1.751* (0.670)	0.249 (0.913)
Openness	–0.009 (0.010)	–0.022 (0.011)	–0.011 (0.012)	0.002 (0.009)	–0.011 (0.010)
Capital Liberalization	–1.517 (0.952)	–0.945 (1.023)	–0.909 (1.085)	–0.608 (0.673)	–0.037 (0.819)
Size (log)	1.064*** (0.283)	0.960** (0.305)	1.212*** (0.326)	–0.148 (0.204)	–0.251 (0.240)
Non-Financial Sectors (log)	3.550** (1.194)	3.153* (1.282)	5.483*** (1.315)	–1.933* (0.759)	–2.330* (0.915)
Democracy	0.431* (0.213)	0.217 (0.225)	0.385 (0.220)	0.0456 (0.090)	–0.168 (0.125)
Constant	–18.905* (7.479)	–17.448* (8.170)	-22.126* (8.698)	3.221 (5.595)	4.678 (6.617)
Log Likelihood:198.398 Pseudo R2: 0.336 Observations: 229					

Note: Statistics with *, **, *** are significant at 10%, 5%, and 1% level, respectively.
Standard errors are in parentheses.

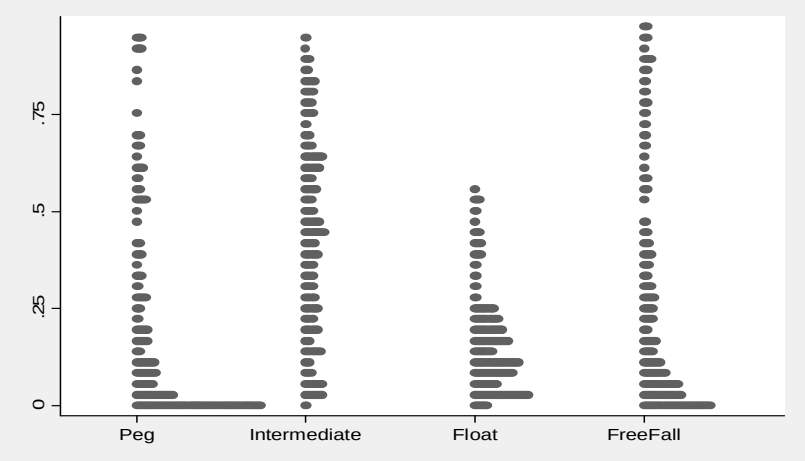

Figure 4.5: Predicted probabilities from a multinomial logit model

As an alternative method of estimation, I use generalized estimating equations (GEE) to account for within-group correlations in logistic regression. GEE models allow for specifying the within-group correlations structure for the panels and adjusting the intra-cluster correlation (table 4.10, column 1).[195] While most results remain unchanged, caution is in order, for the coefficient on CBI changed the sign and became statistically insignificant. I also estimate random effect GLS using the fine R&R measure with 15 categories of exchange rates as the dependent variable to test the sensitivity that cut-off points do not lead to biased results (table 4.10, column 2). I obtain similar results to the baseline model.[196]

[195] These models correspond to population-average (or marginal) models in the panel data literature.

[196] Because in the R&R fine classification, where exchange rate regimes run from 1–15, with 1 representing the most rigid regimes and 15 the most flexible regime, we have to reverse the interpretation of the regression results.

Endogeneity Issues

Empirical research on exchange rate regimes faces *endogeneity* problems (simultaneity). While most of my exchange rate regime choice determinants are not subject to endogeneity, some may reflect a possible reverse causality; that is, the determinants may be the consequences of exchange rate regime performance. They are, therefore, potentially endogenous to the exchange rate regime choices (Levy-Yeyati et al. 2002). These include foreign ownership of banks.[197]

My primary hypothesis is that the higher the degree of private and foreign ownership, the greater the likelihood that governments will adopt and sustain fixed regimes. Nonetheless, some argue that foreign banks may be unwilling to invest capital in countries where the government owns and controls the domestic banking system. Therefore, strategic choices of foreign banks may themselves lead to the politicized finance pathologies associated with government ownership of banks and more flexible regimes. In addition, governments may implement regulatory barriers to foreign entry to limit the degree of foreign bank participation.

Reverse causality, if present, will produce overestimated coefficients. The literature on the endogeneity of exchange rate regimes has been largely inconclusive. The problem of endogeneity can be resolved in different ways: by using instrumental variables or by estimating a system of simultaneous equations. Given that there are many potential economic as well as political variables that can be used, it might be difficult to estimate so many equations.

[197] Other examples include inflation or openness. The use of a currency peg leads to lower inflation rates, but, in turn, inflation is also an important determinant of exchange rate regime choice. Similarly, the exchange rate stability provided by a currency peg reduces exchange rate volatility and thus may foster trade. In turn, trade openness is one of the principal economic determinants of fixed exchange rate regimes.

Table 4.10: Determinants of De Facto Exchange Rate Regimes

Robustness: Alternative Estimation Methods

	Generalized Estimating Equation (GEE)[198]	*Random Effects GLS*
Financial Development	0.348	–0.306*
	(0.124)	(0.139)
Central Bank	–1.851	–6.375***
Independence	(1.032)	(1.572)
Currency Mismatch	0.148	0.635**
(log)	(0.176)	(0.194)
High Inflation	–1.359	1.544*
	(0.613)	(0.631)
Openness	0.015	0.017
	(0.006)	(0.010)
Capital Liberalization	–0.342	–0.112
	(0.481)	(0.603)
Size (log)	–0.437	0.907*
	(0.153)	(0.379)
Non-Financial Sectors	–1.726	1.825**
(log)	(0.577)	(0.886)
Democracy	0.162	–0.233
	(0.073)	(0.141)
Constant	7.809	–6.805
	(4.125)	(9.372)
	Observations: 229	Observations:
	Wald chi-square:	229
	48.97	R-square: 0.180

Note: Statistics with *, **, *** are significant at 10%, 5%, and 1% level. Standard errors are in parentheses.

In order to minimize the potential endogeneity problem, I first instrumentalize all right-hand-side variables in my model by using their own one-year lagged values as instruments in all regressions estimated above. This method assumes that the exchange

[198] Please note that in contrast to the random effects model, in which coefficients represent expected differences (odds ratios, etc.) within an individual, given a change in their X from one value to another, coefficients in a GEE model represent expected differences within a population, given a change in everyone's X from one value to another.

rate regime choice is ex-ante optimal, meaning that policy makers choose an exchange rate regime for the current period on the basis of the previous period's performance.

Second, to examine whether endogeneity is a serious issue in this context, I also re-estimated my baseline regression by using the instrumental variable (IV) approach instrumenting for my primary variable—financial development. The excluded instruments have to be strongly correlated with the endogenous independent variables but have no direct impact on the dependent variable. Therefore, instrumental variables can only affect the dependent variable through the explanatory variables.

Based on the argument advanced in chapter 3, I instrument the principal financial development variable with the method of privatization variable. Method of privatization does satisfy the exclusion restriction—that is, it has almost certainly an independent impact on the probability of exchange rate pegging. Exogeneity is not a sufficient condition for economically meaningful instrumental variables (Levine, Loyaza and Beck 2000), so I have provided the reasons that the method of privatization is closely connected to factors that directly affect the behavior of financiers and financial institutional development in chapter 3. I am not aware of the arguments in the existing literature that link a country's privatization method to an exchange rate regime determination. Following Levine (2002), I use an additional instrument to deal with endogeneity of foreign banks entry—the absolute value of the latitude of the country—to capture regulatory restrictions on foreign entry. Geography-based instruments are commonly used in the finance and growth literature. The rational behind the choice of this instrument is the argument provided by Acemoglu, Johnson, and Robinson (2001) that geographical endowments influence institutions, including national views toward openness and competition.[199] Hall and

[199] A common instrumental variable used to control for the endogenous determination of financial development is legal origin—English common law, French, German, Scandinavian civil law—

Jones (1999) also show that geography, latitude in particular, is strongly correlated with high quality institutions. I have not identified any literature in which latitude independently affects exchange rate regime choices and hence violate the exclusion criterion.

I use the IV strategy in the context of the generalized method of moments (GMM) estimation (and report Newey-West standard errors) to address the potential problem of heteroscedasticity and serially correlated errors.[200] GMM is usually used when facing heteroscedasticity of unknown form because standard IV estimators (though consistent) are inefficient in the presence of heteroscedasticity, preventing valid inference (Baum, Schaffer, and Stillman 2003).[201] My dependent variable in the baseline model is dichomous—fix or float—and thus logit or probit models would be the standard estimation method. Nonetheless, I am not aware of an IV estimator for a dichotomous dependent variable with heteroscedasticity and serially correlated errors, or of statistical tests for instrument strength and exogeneity.[202] Following Eichengreen and Leblang (2006), I will estimate linear probability models. As a consequence, parameter estimates cannot be interpreted in terms of probabilities and predicted values may fall outside the zero-one interval.

Testing the validity of the moment conditions (instruments) is crucial to ascertaining the consistency of GMM estimates. I test the relevance (strength) and

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developed by La Porta et al. (1998). Nonetheless, this instrument is not appropriate for my sample, for all EE countries are classified as a "socialist" legal system in the above database.

[200] The GMM was introduced by Lars Hansen (1982).

[201] The GMM estimator is more efficient than the simple IV estimator in the presence of heteroscedasticity, and if the errors are neither heteroscedastic nor serially correlated, it is not worse asymptotically than the IV estimator (Baum, Schaffer, and Stillman 2003).

[202] Heteroscedasticity tests (Breusch-Pagan/Godfrey/Cook-Weisberg test) using levels of IVs as well as fitted value and its square that I conducted, signal problems of heteroskedasticity in the estimated equation's disturbance process.

exogeneity of instrumental variables (i.e., that they satisfy the exclusion restrictions) performing two tests: First, I calculate an F-test for the exclusion of the instrument(s) based on the first stage regressions and consider my instrument(s) strong if the F-statistics is greater than ten (Staiger and Stock 1997). I also use the Cragg-Donald test of the null hypothesis of under-identification,[203] Proceeding if the instruments satisfy both tests. Finally, the Hansen test of over-identifying restrictions in a GMM context (called the J statistic) tests the null hypothesis that the model is not overidentified.[204] In the context of the exchange rate regressions, moment conditions mean that privatization method may affect the exchange rate regime choice only through the financial development indicators and the variables in the conditioning information set (that is, the other exchange rate regime determinants).

Table 4.11 reports results of GMM estimation. The F-statistics from the first stage regressions for the joint significance of the instruments is relatively high with low p-values, providing support for the instruments used in the exchange rate equations. The instruments are significant in the first stage equations and they satisfy the Cragg-Donald test of under-identification. Similarly, the Hansen J-test of over-identification of all instruments does not cast doubt on the instruments' validity. The coefficient on financial development has retained both its statistical and economic significance in all three estimations and after using alternative measures of CBI and currency mismatches. The novel instrument of financial development proposed by this study yields the expected result: the direct sales method of privatization leads to higher levels of financial institutional development. Although the coefficients for central

[203] The rank condition requires that there be enough correlation between the instruments and the endogenous variables to guarantee that unique parameter estimates can be computed. If the rank condition fails, the equation is considered to be underidentified (Baum 2006: 191).

[204] The null hypothesis of Hansen's test is that the overidentifying restrictions are valid; that is, the instrumental variables are not correlated with the error term.

bank independence retained their statistical significance, they shifted in the opposite direction.

This result is yet another proof that the direction in which an independent central bank influences exchange rate regime choice is not clear. Column (1) estimates the equation instrumenting financial development using privatization, while column (2) adds latitude. Column (3) replicates column (2) but uses alternative measures of currency mismatches and CBI. I use Levy Yeyati's (2004) deposit dollarization ratios as an alternative measure of currency mismatches and CMN indices of central bank independence.[205] Column (4) eliminates all controls and finds that the relationship between financial development and the probability of exchange rate peg remains positive and statistically significant.[206]

Beyond econometric tests, we can use the broad historical and empirical evidence to form a judgment on the endogeneity of our explanatory variables to exchange rate regime choices. To this end, I have carefully traced the process of exchange rate making in four countries of EE in the case study chapters of my dissertation.

[205] Other potential measures of currency mismatches are Eichengreen et al. (2002) "ability to pay" measures and the ratio of foreign liabilities in the domestic financial sector relative to money stocks (Levy-Yeyati, Sturzenegger, and Reggio 2007).

[206] Following Levy, Yeyati, Sturzenegger, and Reggio (2007), I have further estimated (but not reported here) the GMM models using two instruments for de jure central bank independence and currency mismatches—the rule of law and voice and accountability—taken from the World Bank's Governance Indicators (Kaufmann, Kraay, and Mastruzzi 2007). Although these instruments perform well in terms of identification and exogeneity, they have not passed the Hansen test of overidentification.

Table 4.11: Determinants of De Facto Exchange Rate Regimes

Estimation: Instrumental variables regression estimated via Generalized Method of Moments

	(1)	*(2)*	*(3)*	*(4)*
Financial Development$_{t-1}$	0.067**	0.068**	0.107***	0.092***
	(0.022)	(0.022)	(0.025)	(0.010)
Central Bank Independence$_{t-1}$	–0.383*	–0.423*	–0.583**	
	(0.180)	(0.178)	(0.200)	
Currency Mismatch (log)$_{t-1}$	0.022	0.016	0.004	
	(0.026)	(0.026)	(0.002)	
High Inflation$_{t-1}$	–0.230*	–0.213*	–0.221*	
	(0.104)	(0.103)	(0.096)	
Openness$_{t-1}$	0.002*	0.002*	0.003*	
	(0.001)	(0.001)	(0.001)	
Capital Liberalization$_{t-1}$	–0.057	–0.060	–0.212*	
	(0.091)	(0.091)	(0.085)	
Size (log)$_{t-1}$	–0.080**	–0.084***	–0.065*	
	(0.025)	(0.025)	(0.027)	
Non-Financial Sectors (log)$_{t-1}$	–0.293**	–0.313***	–0.302**	
	(0.092)	(0.091)	(0.103)	
Democracy$_{t-1}$	0.030*	0.026*	0.007*	
	(0.012)	(0.012)	(0.016)	
Constant	1.949**	2.116**	1.546*	0.103*
	(0.681)	(0.675)	(0.743)	(0.046)
Observations	228	228	173	283
F	19.55	21.74	27.01	91.78
(p-value)	0.000	0.000	0.000	0.000
First Stage F	421.40	282.89	148.74	1914.02
(p-value)	0.000	0.000	0.000	0.000
Cragg-Donald Under-ID Test	739.10	739.13	439.48	3719.07
(p-value)	0.000	0.000	0.000	0.000
Hansen J Statistic	0.190	3.444	1.512	0.346
(p-value)	0.669	0.179	0.470	0.556
Instruments	Privatization Fin dev$_{t-2}$	Privatization Latitude Fin dev$_{t-2}$	Privatization Latitude Fin dev$_{t-2}$	Privatization Fin dev$_{t-2}$

Note: White's heteroscedasticity consistent and auto-correlation robust standard errors in parentheses. Instruments refer to the set of exogenous instruments used in the first stage regressions. The F-test refers to the F-test for the second stage model. The first stage F is the heteroscedasticity and auto-correlation robust F-test for testing the exclusion of the instruments from the first stage. Cragg-Donald under-identification tests the null hypothesis that the first stage is under-identified. The null hypothesis of the Hansen J test of over-identifying restrictions is that the instruments used are not correlated with the residuals. Statistics with *, **, *** are significant at the 10%, 5%, and 1% levels.

Conclusion

This chapter accomplished two tasks. One, in the first part I present a new empirical measure of the key explanatory variable—financial development—to capture the influence of financial interests and institutions in choice and sustainability of exchange rate regime. Two, with this empirical measure of national financial development and other financial variables, I developed a finance-based political economy model, while controlling for economic and political variables identified in the literature on exchange rates. I tested my theoretical prediction in the context of 25 transition economies of EE between 1990 and 2004.

I show that existing theories on exchange rates are incomplete because they do not consider the effect of bank ownership and institutional structures on governmental choices of exchange rate regimes. Panel logit models of exchange rate regime determination in EE are largely consistent with the central prediction that countries with financial systems characterized by greater participation of foreign and private banks in the bank intermediation, accompanied by strong monetary and regulatory institutions, are more willing and able to commit to and sustain fixed exchange rate regimes than countries with financial systems dominated by incumbent SOBs. I also show that the de facto exchange rate regimes in EE diverge considerably from what is announced. These effects largely persisted against a variety of robustness checks, including different measures of financial development, different model specifications, and estimation methods. Finally, in contrast to many existing studies, I address the problem of endogeneity using an IV approach via GMM estimation with a novel instrument for financial development—the method of privatization of banks and industries—derived from my theory of financial institutional development in EE that I closely examine in chapter 3.

This research suggests new directions for research on the choice of exchange rate regime that accounts for the role of financial institutional structures in exchange rate policy. Results from these large-n quantitative analyses demonstrate that the hypotheses derived from the theory in Chapters 2 and 3 contribute to explaining choices that governments make with regard to exchange rate regimes. The subsequent chapters will build on the theoretical frames and statistical results, and examine the specific processes and the mechanisms that link the changes in financial institutional structures to exchange rate regime choices, first comparatively in all EE states (chapter 5) and then in four case studies. Chapters 6, 7 and 8 will present comparative examinations of exchange rate policy making in Estonia, Bulgaria, Poland and the Czech Republic.

CHAPTER 5

EXCHANGE RATE POLICIES IN TRANSITION

Foreign exchange allocation is a useful channel
for political favoritism and/or personal enrichment,
by political leaders and by administering officials alike.

Richard N. Cooper[207]

This chapter surveys the remarkable diversity of exchange rate regimes in the post-communist states of EE. It also explores the extent to which this heterogeneity corroborates the argument that policymakers are more likely to choose and sustain fixed exchange regimes when they pursue stabilization and privatization policies that constrain political influence of incumbent financial and industrial interests. The ability of central banks to detach themselves from these established inflation lobbies is also an important element of stable currency policy. Independent central banks are among the main forces behind the imposition of "hard budget" constraints on banks and enterprises. In contrast, governments were not able to commit to sustainable fixed regimes when monetary policy continued to be a source of redistribution by preferential allocation through SOBs of credit to enterprises and agricultural producers, often in an environment of high inflation and negative interest rates.

In chapter 3, I examined the role of privatization and financial liberalization in financial system development in EE. In this chapter I explore indirectly the role of incumbent and foreign banks in exchange policies by examining national financial development strategies that empowered different types of banks and shaped the responsiveness of politicians to their demands. While the statistical chapter 4 has established empirical links between various independent and contributory effects of financial factors on the probability of fixing the exchange rate, this chapter illustrates

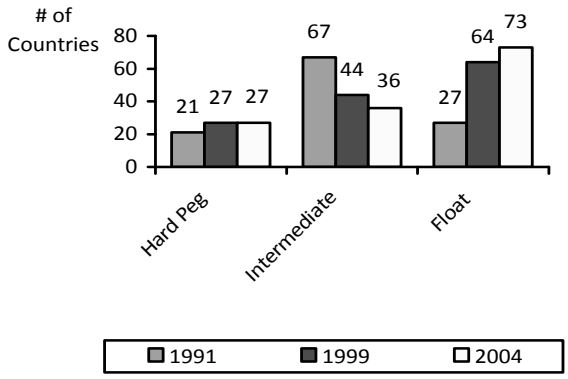
[207] Cooper (1997: 465).

these effects comparatively by exploring exchange rate histories in all EE states over time. Furthermore, I explore the reasons behind the discrepancies between the official and actual choices of governments with regard to exchange rate regimes in individual EE states that I have shown in chapter 4 on the aggregate data. I also identify the outliers, that is, the cases that do not seem to be comprehensive in terms of my theoretical framework. Finally, this chapter provides comparisons for how well the finance-based theory performs against rival hypotheses. While they provide important insights into some aspects of policy-making in EE, I will show that there are no existing theoretical approaches that account for the wide variety of exchange rate strategies in the transition region. The discussion in this chapter is far from conclusive in terms of empirical evidence. Rather, it suggests the plausibility of the argument and supplements the statistical chapter and in-depth case studies by offering a broad assessment of exchange rate policies in the EE region.

After the collapse of the Soviet-type socialist system, the choice of exchange rate regime was seen as a major policy decision in EE countries (Pomfret 2003: 600). Exchange rate strategies throughout the transition impacted progress in decreasing inflation, the management of capital flows, and external competitiveness of the EE economies . Nonetheless, exchange rate policy in EE cannot be considered in isolation. This chapter situates it in the context of the overall transformation process, which is the interaction of initial conditions after the collapse of communism and institutional characteristics, as well as economic and political transition strategies. So, I first briefly examine initial conditions after the collapse of communism and then trace empirically the evolution of exchange rate regimes choices (voluntary and forced) in EE states in different periods of the post-communist transition.

Before we turn to the post-communist region of EE, let me briefly explore exchange rate evolution in a comparative perspective. Following the collapse of the

Bretton Woods system of fixed exchange rates in 1973, the practice of fixing exchanges was generally abandoned by the major countries in Europe and Japan, and there has been a gradual shift from fixed to more flexible exchange rates. The movement toward hard pegs in Europe reflects mostly the monetary unification project.[208] Many developing countries still pegged their currencies in the 1970s either to a single currency (the U.S. dollar or French franc) or to a basket of currencies.[209] In the 1990s, they officially shifted away from currency pegs and intermediate regimes towards more flexible exchange rate arrangements (figure 5.1).[210]



Source: Obstfeld (2007: 37).

Figure 5.1: Changes in exchange-rate flexibility in developing countries, 1991–2004

Nonetheless, many developing countries—including transition economies, as this study shows—manage their exchange rates to a greater extent than announced. In fact, soft pegs have shown remarkable durability (Rogoff et al. 2003). De facto intermediate regimes still account for one-third to one half of regimes in developing

[208] The members of the European Community created the European Monetary System in 1979, which in 1999 evolved into the European Monetary Union (EMU) with a common currency.

[209] All the IMF member countries not classified as industrial countries are considered as "developing" countries here. Emerging market and transition economies are included in this sample.

[210] For a historical perspective on exchange rate regimes, see Bordo (2004), Eichengreen (1996).

contexts (Eichengreen and Razo-Garcia 2006). The choice of the exchange rate regime for developing and transition countries is thus different from that of developed ones. The monetary authorities of developing countries lack credibility and have limited access to international markets. Compared to industrialized countries, these countries suffer from more pronounced adverse effects of exchange rate volatility on trade, high liability dollarization, and higher pass-through from the exchange rate to inflation. In developing contexts, exchange rate devaluation is always connected with the loss of output and recession, yet in developing countries, devaluation spurs growth.[211]

Initial Conditions

As argued in chapter 1, EE states started the post-communist transition with a political legacy of authoritarianism and common legacies of central planning.[212] In particular, they started with a common set of economic distortions inherited from the communist era (table 5.1). These included repressed inflation, extreme shortages in consumer and producer markets, large fiscal deficits and debts, uncompetitive production, and weak trade and financial links with Western markets (de Melo et al. 2001). Their industrial structures shared similar features: high shares of industry and manufacturing and repressed service sectors.[213] Most countries, particularly Bulgaria, Croatia, Hungary, and Poland, inherited large external debts.[214] As a consequence of

[211] Maurice Obstfeld. International Economics course, lecture on March 20, 2007, Department of Economics, University of California, Berkeley.

[212] Hanson (1995) further breaks down the communist legacies into ideological, political, socioeconomic, and cultural components. On the legacies of communism, see also Jowitt (1992), Hanson and Ekiert (2003).

[213] Only in Croatia, Hungary, and Slovenia did services represent fifty percent of GDP. Ideological considerations that held nonmaterial output to be "unproductive" were one of the main reasons behind the suppression of services during communism (de Melo, et al. 2001: 4, fn. 8).

[214] Russia assumed all the Soviet era foreign debt and thus freed other post-Soviet republics from past international obligations (Fisher and Sahay 2000: 10).

communist policies, intended to create an interdependent communist trade bloc, external trade flows were concentrated within the Council for Mutual Economic Assistance (CMEA).[215] The breakdown of the CMEA and the collapse of the Soviet Union severely disrupted international trade and payments in most EE countries. In the monetary realm, EE countries had non-convertible currencies and a large black market premium on the exchange rate.[216]

In sum, all EE countries started the transition with a deep economic crisis and dislocation with the exception of the former Czechoslovakia, which had a stable economy and low foreign debt (Sachs 1996: 147). While I stress these similar starting points in terms of domestic economic and political structures in EE, I recognize some variation in background conditions that might have affected post-communist trajectories. Nonetheless, as this study shows, most of these differences in initial conditions, identified in the existing literature, fail to explain the different exchange rate regime outcomes in EE states.

[215] The inter-republic exchanges accounted for around 85 percent of trade in 1991 for the post-Soviet states, except for Russia and Ukraine.

[216] A high black market exchange rate premium, that is, a differential between the official and the free exchange rate is an indicator of depreciation expectations. It represents a distortionary tax on exports and a subsidy on imports. Black market premiums were the highest in the ex-Soviet states, Bulgaria, and Romania (de Melo et al. 2001: 8).

Table 5.1: Initial Conditions

Country	*Democracy index 1990–1992*[1]	*Income per capita GNP at Purchasing Power Parity USD1989*	*Share of industry in GDP in 1990 current prices (%)*	*Natural Resources*	*Repressed inflation 1987–1990*[2] *(%)*	*Trade dependence 1990*[3] *(%)*	*Black market premium 1990 (%)*	*Years under central planning*
Albania	13	1,400	37	Poor	4.3	6.6	434	47
Armenia	10	5,530	55	Poor	25.7	25.6	1,828	71
Azerbaijan	10	4,620	44	Rich	25.7	29.8	1,828	70
Belarus	8	7,010	49	Poor	25.7	41.0	1,828	72
Bulgaria	7	5,000	59	Poor	18	16.1	921	43
Croatia	7	6,171	35	Poor	12	6.0	27	42
Czech Republic	4	8,600	58	Poor	–7.1	6.0	185	42
Estonia	5	8,900	44	Poor	25.7	30.2	1,828	51
Georgia	11	5,590	43	Moderate	25.7	24.8	1,828	70
Hungary	4	6,810	36	Poor	–7.7	13.7	47	42
Kazakhstan	9	5,130	34	Rich	25.7	20.8	1,828	71
Kyrgyz Republic	9	3,180	40	Poor	25.7	27.7	1,828	71
Latvia	5	8,590	45	Poor	25.7	36.7	1,828	51
Lithuania	5	6,430	45	Poor	25.7	40.9	1,828	51
Macedonia, FYR	7	3,394	43	Poor	12	6.0	27	47
Moldova	9	4,670	37	Poor	25.7	28.9	1,828	51
Poland	4	5,150	52	Moderate	13.6	8.4	277	41
Romania	11	3,470	59	Moderate	16.8	3.7	728	42
Russia	6	7,720	48	Rich	25.7	11.1	1,828	74
Slovak Republic	4	7,600	59	Poor	-7.1	6.0	185	42
Slovenia	5	9,200	44	Poor	12	4.0	27	46
Tajikistan	6	3,010	34	Poor	25.7	31.0	1,828	71
Turkmenistan	11	4,230	34	Rich	25.7	33.0	1,828	71
Ukraine	6	5,680	44	Moderate	25.7	23.8	1,828	74
Uzbekistan	11	2,740	33	Moderate	25.7	25.5	1,828	71

[1]Freedom House Democracy Index (political rights and civil liberties) in 1990 or in the first year for which the score is available.
[2]Repressed inflation is defined as the percentage change in real wages less the percentage change in real GDP.
[3]Trade dependence is defined as the ratio of CMEA exports and imports to GDP.
Source: Adapted from De Melo, Denizer, Gelb and Tenev (2001), Freedom House: Nations in Transit, various issues

EE states implemented political and economic reforms simultaneously in the early 1990s.[217] The economic agenda of post-communist reformers was based on a similar menu: macroeconomic stabilization to overcome the damages of high inflation; privatization of state enterprises and banks; liberalization of markets to allow open entry and competition; and institutionalization of rule of law and the protection of property rights (Havrylyshyn and Olding-Smee 2000: 8).[218] In the initial reform phase, fighting against high inflation and establishing credibility on international markets were the top priorities of policymakers in most EE states. Because of earlier liberalization steps, open inflation was chronic in Poland and the former Yugoslav republics in 1989. But repressed inflation, in the form of a monetary overhang, was high across the EE region (de Melo et al 2001: 7).[219] So, price liberalization at the beginning of the transition resulted in high inflation (and a wage-price inflationary spiral in some countries) and a dramatic fall of output in most EE states.[220] As table 5.2 shows, the 12-month pre-stabilization inflation rates ranged from hyperinflation of 57 thousand percent per annum in Georgia to 26 percent in Hungary.[221]

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[217] Nation and state building have also been central to post-communist development. Virtually all EE transitions were national liberations either from the Soviet bloc or from domination by a federal state. On post-communist multiple transitions, see Bunce (1999).

[218] It has been argued in post-communist studies that democratization and economic reforms are highly correlated in EE: more democratic countries feature capitalist economies. See Hellman (1998), Fish (1998), Bunce (1998), Kopstein and Reilly (2000), Kurz and Barnes (2002). A slightly different picture might emerge if we disaggregate economic reforms. Failed financial sector reforms with deleterious consequences for economic development in the Czech Republic, one of the most successful democracies in EE, might put this general phenomenon in question.

[219] Some countries initiated partial liberalization before the collapse of communism: Yugoslavia abandoned formal planning in the 1950s; Poland initiated reforms in 1968 and Hungary did so in 1981.

[220] High inflation accompanied by a drastic fall in output and negative growth is called *stumpflation*.

[221] The worst hyperinflation in the EE region (in Georgia in 1992–1994 and in the former Yugoslavia in 1992–1993) was driven by war finance. Military assistance from Russia reduced the need for inflationary war finance in civil war torn Tajikistan (Pomfret 2003: 604).

Exchange Rate Strategies

An important element of the initial stabilization strategy aimed at combating high inflation was the choice of exchange rate regime (Fisher and Sahay 2000). A currency peg has been regarded as the most effective strategy to combat inflation, to stabilize the economy, and to facilitate the introduction of current account convertibility.[222] For countries with a history of high inflation, weak and unstable governments, and non-credible monetary institutions, a fixed regime can signal the commitment towards exchange rate stability. An exchange rate commitment is particularly desirable in societies where central banks are not independent or lack public and political support for market-based discipline (Wyplosz 1999: 17).

Even for countries that started the transition with lower inflation rates, the "Washington consensus," actively promoted by the IMF through conditionality loans, held that a fixed exchange rate was the appropriate nominal anchor for stabilization, provided that fiscal policy was sustainable (Von Hagen and Zhou 2002: 7).[223] Credible and sustainable exchange rate-based stabilization programs, however, required a political will to depoliticize the allocation of credit and to create an independent banking sector by privatizing SOBs. Directed credit that dominated the lending operations of many SOBs has been a major source of inflation in the post-communist region.

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[222] Liberalization of the current account was accompanied by substantial initial devaluation of domestic currencies, which were strongly overvalued under central planning, to restore a balance between supply and demand for currencies as well as to stimulate exports and to curb imports.

[223] International financial institutions (IMF, World Bank, and EBRD) made financial aid and technical support to transition economies conditional on adopting structural adjustment policies used by these institutions to address structural crises in developing countries, especially in Latin America. The Washington Consensus list of policies, codified in Williamson (1994) included fiscal discipline, reorientation of public expenditures, tax reform, financial liberalization, unified and competitive exchange rates, trade liberalization, openness to foreign investments, privatization, deregulation, and property rights. The Washington consensus has been under attack since the mid-90s. Stiglitz (2000) criticized IMF bailout conditions during the financial crisis in East Asia, imposing stringent stabilization measures that caused severe recessions in the region. For a recent criticism of the Washington consensus, see Rodrik (2006).

Table 5.2: Exchange Rates and Inflation Stabilization, 1990–2004

Country	*Stabilization program date*	*Initial Exchange Rate Regime (De Jure)*	*Pre-Program Inflation[1]*	*Max Annual Inflation (Year)*	*Year in which inflation fell below 50%*	*National currency adopted (sole legal tender)*	*Exchange regime in 2004 (De Facto)*
Albania	Aug 92	Fixed	293	237 (‘92)	1993	NA	Flexible
Armenia	Dec 94	Flexible	1885	10896 (‘93)	1995	Nov 93 (Nov 93)	Fixed
Azerbaijan	Jan 95	Flexible	1651	1787 (‘94)	1996	Aug 92 (Jan 94)	Fixed
Belarus	Nov 94	Flexible	2180	1997 (‘93)	1996	May 92 (May 94)	Flexible
Bulgaria	Feb 91	Flexible	245	579 (‘97)	1998	NA	Fixed
Croatia	Oct 93	Fixed	1903	2585 (‘89)	1994	Dec 91	Fixed
Czech Republic	Jan 91	Fixed	46	52 (‘91)	1992	Feb 93	Fixed
Estonia	Jun 92	Fixed	1086	947 (‘92)	1993	Jun 92 (Jun 94)	Fixed
Georgia	Sep 94	Flexible	56476	7486 (‘93)	1996	Apr 93 (Aug 93)	Flexible
Hungary	Mar 90	Fixed	26	35 (‘90)	NA	NA	Fixed
Kazakhstan	Jan 94	Flexible	2315	2961 (‘92)	1996	Nov 93 (Nov 93)	Fixed
Kyrgyz Republic	May 93	Flexible	934	958 (‘92)	1993	My 93 (May 93)	Flexible
Latvia	Jun 92	Flexible	818	1162 (‘92)	1993	May 92 (Jul 92)	Fixed
Lithuania	Jun 92	Flexible	709	1162 (‘92)	1994	May 92 (Oct 92)	Fixed
FYR Macedonia	Jan 94	Flexible	248	1780 (‘92)	1995	Apr 92	Fixed
Moldova	Sep 93	Flexible	1090	2198 (‘92)	1995	Jul 93 (Jul 93)	Flexible
Poland	Jan 90	Fixed	1096	640 (‘89)	1992	NA	Flexible
Romania	Oct 93	Flexible	314	295 (‘93)	1995	NA	Flexible
Russia	Apr 95	Flexible	218	2510 (‘92)	1996	Jul 93 (Jul 93)	Fixed
Slovak Republic	Jan 91	Fixed	46	58 (‘91)	1990	Feb 93	Flexible
Slovenia	Feb 92	Flexible	288	247 (‘91)	1993	Oct 91	Fixed
Tajikistan	Feb 95	Flexible	73	7344 (‘93)	1994	May 95 (May 95)	Flexible
Turkmenistan	NA	Flexible	20	9743 (‘93)	1997	Nov 93 (Nov 93)	Flexible
Ukraine	Nov 94	Flexible	645	10155 (‘93)	1990	Sep 96 (Sep 96)	Fixed
Uzbekistan	Nov 94	Flexible	1555	1281 (‘94)	1996	Nov 93 (Jan 94)	Flexible[2]

Source: Fisher and Sahay (2000), Reinhart and Rogoff (2004), Eichengreen and Razo-Garcia (2006), IMF Annual Reports on Exchange Rare Regimes and Restrictions, Abdelal (2001), Johnson (2000).

[1]Pre-program inflation is inflation in the 12 months prior to the month of the stabilization program. Inflation is calculated from December to December.

[2]De Jure exchange rate regime since Reinhart and Rogoff (2004) do not report the de facto regime.

In the demobilized post-communist context at the outset of the transition in 1989, macroeconomic stabilization and institutional reforms were carried out through the concentrated power of the technocratic elite who had considerable discretion over economic policies. These technocrats were "the necessary, if not sufficient prerequisites" of drastic economic reforms, including costly anti-inflationary programs (Williamson 1994). The extrication of government from societal pressures at the beginning of the transition was facilitated by the fact that interest groups, old and new, had not yet defined their interests and a system of lobbying or interest group organization, through which to consolidate opposition to radical reforms was lacking (Ost 1993). Nonetheless, as I argued in the preceding chapters, the success of stabilization and its accompanying financial sector reforms along with the specific factors in the design of these reforms reflected the initial constellations of political coalitions between the state and economic interests (financial and industrial) at the outset of transition (initial conditions) and the choices made by the new governments concerning financial liberalization and transfer of state assets to private hands.[224] The diverse patterns of state asset transfer and financial system development that resulted explain a great deal about the variation of exchange rate regimes among EE states. Table A.4 in the Appendix displays strategies that the EE central banks adopted in exchange rate management from 1990–2004.

The Early Peggers: Stabilization and Financial Openness

Societies existed in which serious reformers facing relatively favorable initial economic conditions were able to secure political support for market reforms and cut ties with the incumbent interests from the socialist era and newly created rent-seeking

[224] I am not addressing the issue of the appropriate speed of property transfer or the speed and sequence of reform measures, which were hotly debated in the initial years of transition.

interests through financial liberalization and privatization of SOBs and enterprises to outsiders during the early stages of transition.[225] These governments were able to limit the deleterious effects of insider privatization of banks and industries, discussed in chapter 3. Financial openness smoothed the path for competition and easy entry by new private banks, enterprises, and foreign investors. It undermined the monopolistic position of the old communist coalitions of party hierarchy and prevented managers of SOBs and state monopolies from draining state resources and from asset stripping. These conditions, in turn, allowed the governments to implement sufficient monetary and fiscal controls to support a dismantling of their interventionist and protectionist policies, to commit to consistent stabilization and reform programs (table 5.2).

Governments in these societies were more likely to adopt fixed exchange rate regimes, sometimes as a part of the IMF exchange-rate based stabilization programs, to pursue price and financial stabilization and hard budget constraints.[226] International banks and new private banks and enterprises without political baggage are better able to survive without state protection. They are more receptive to structural adjustments and less likely to pressure governments for exchange rate adjustments. The entry of foreign investors interested in macroeconomic stability and fixed regime was an important step in this direction (Korhonen 1999: 17).

Early peggers–Poland, Hungary, the Czech Republic, Slovakia, and the Baltic States–outperformed the floaters in terms of inflation reduction (table 5.2). Poland was

[225] The argument here is broadly consistent with the literature explaining long-term patterns in economic policy making by focusing on the critical junctures in the political decision-making process. See Przeworski (1991), Frye (2002b), Acemoglu and Robinson (2001). As Bunce (2000: 717) argues, the advantage of a sharp break with an authoritarian regime was the victory of the opposition forces in the first elections, quick construction of democratic institutions and successful economic reforms. See, also Fish (1998), Bunce (1999), Darden and Grzymala-Busse (2006).

[226] EE countries adopted *exchange rate-based* stabilization programs when stabilization was anchored to nominal variables (such as exchange rate or wages); or a *money-based* stabilization program when anchors of stabilization were real variables (real money supply and/or real interest rates). For a discussion on the advantages and drawbacks of different anchors, see Domac et al. (2001). See Bruno (1992) and Gomulka (1995) for comparisons of IMF-agreed stabilization programs in EE.

the first to launch a "shock therapy" program in January 1990.[227] The reform strategy that became widely known as the "Balcerowicz plan," after the Solidarity Minister of Finance, Leszek Balcerowicz, was based on the fixed exchange rate of the Polish zloty to the U.S. dollar. Its objective was to fight against hyperinflation and to restore a stable and convertible currency. The comprehensive stabilization and liberalization program adopted by the opposition Solidarity government was the expression of its willingness to cut ties radically with the communist regime. Stabilization was accompanied by massive cuts in fiscal subsidies, strict bad loan regulation in the banking sector, and bank privatization that included placement with foreign investors.

Hungary initially opted for a gradualist money-based approach to stabilization focused on improving the trade balance but it was combined with a fixed exchange rate regime. Nonetheless, after a "reform pause" around the mid-1990s, the monetary policy became more expansionary and the country suffered from persisting fiscal and current account deficits. The Socialist government of Lajos Bokros adopted an austerity package in 1995, supported by the governor of the National Bank of Hungary (NBH) Gyorgy Surányi. The centerpiece of the package was a greater weight assigned to the fixed exchange rate in a disinflation strategy (Burdekin, Nelson, and Willett 1999: 114). Exchange-rate-based stabilization was accompanied by banking sector reform. In fact, Hungarian banks withdrew from enterprise sectors in terms of both lending and ownership from the very early days of transition. Banks restructured their

[227] In the first years of transition, a hotly debated issue was the speed of the transition, stemming from the difference between two paths of transformation in EE: Poland launched a "shock therapy" model (also called "Big Bang" or "cold turkey"), while Hungary adopted a gradualist approach. The proponents of the first approach (Sachs 1993, Lipton and Sachs 1990, Fisher and Gelb 1991) expressed intellectual and political commitment to a monetarist vision of economic management stressing the importance of simultaneous macroeconomic stabilization and structural reforms. They called for rapid privatization to avoid asset stripping and to prevent newly formed vested interest groups from blocking privatization later. The proponents of gradualism (Dewatripont and Roland 1992, Aghion and Blanchard 1994, Murell 1993) underlined the high adjustment costs of rapid changes resulting in terms of unemployment and political costs of reforms. The latter group put greater emphasis on building institutions and market infrastructure as a crucial pre-condition for successful liberalization. Beyond these differences, both radical and gradual reform approaches shared many common elements.

loan portfolios before they were privatized through case-by-case, cash-based privatization to foreign investors. The government was able to assist in the financial reform by injecting new capital into the big banks but at the same time imposing strict financial regulation (Barnes 2003).[228]

There are good reasons to conclude that the accounts focusing on the pace of transition or pure pressures of interest groups and economic sectors will be unable to explain the regime choices of the early peggers. Although the speed of reforms in Poland and Hungary differed, both adopted stabilization programs based on fixed regimes. Similarly, both countries, having experimented with political and economic liberalization already in the 1970s and 1980s, began the transition with relatively well-organized societal groups and competing political actors. Although a negotiated mode of exit from communism in both Poland and Hungary provided an additional opportunity for these incumbent interests to entrench themselves, they were not able to capture the state.[229]

In contrast, orthodox communist policies left the former Czechoslovakia (and its successor republics) with poorly organized social and political groups. A strong strategic control of the economy and polity gave the first post-communist government leeway to pursue economic reforms. Similar to Poland, the former Czechoslovakia had initially opted in 1990 for the shock therapy model and a fixed exchange rate regime as part of the IMF stabilization program. The program was adopted less of necessity,

[228] An important piece of legislation discouraging banks from supporting failing enterprises was the 1992 stringent bankruptcy law, according to which bankruptcy proceedings were launched against any enterprise with more than ninety days of loan arrears (Barnes 2003: 549). See, also Bartlet (1996).

[229] EE countries exited communism in different ways: The post-communist regime in Hungary was the outcome of pacted transition, in Czechoslovakia the outcome of mass-mobilized transition, and in Poland and Slovenia the outcome of mass mobilization combined with elite-negotiated transition (Bunce 1999). There are several competing explanations for the variation in the communist exit, focusing on structural factors like geography (Kopstein and Reilly 2000), the legacies of pre-communist development (Kitschelt et al. 1999), the strength of the anticommunist opposition (Bruszt and Stark 1992), and pre-communist schooling (Darden and Grzymala-Busse 2006).

for the macroeconomic indicators were relatively good, than as an expression of the political victory of finance minister Václav Klaus, a radical reformer. He had tried to liberate the government from various social and political groups but was unwilling to cut ties with banks. After the dissolution of Czechoslovakia in 1993, both successor republics—the Czech Republic and Slovakia—continued a fixed regime policy.

The initial reforms in Czechoslovakia provided credibility and strong foundations for the continuation of a fixed regime in Slovakia, allowing the newly established National Bank of Slovakia (NBS) to peg the new national currency, the Slovak koruna. This exchange rate strategy was chosen in spite of a complete lack of foreign reserves and limited access to international capital markets due to the political uncertainty following the division of the federation.[230] Therefore, the Slovak populist–cum–authoritarian government of Vladimír Mečiar (1992–1994) retained a currency peg and restrictive monetary policies from the original transformation blueprint inherited from Czechoslovakia. Still, the government broke down in the areas of privatization and industrial policy, delaying the second wave of voucher privatization and establishing a regime that rewarded political allies—the communist-era enterprise managers—with lucrative privatization deals.

In the Baltic countries, an important component in the economic reforms was currency reform. Russia and the other fourteen post-Soviet republics inherited a ruble zone, a currency union based on the Soviet ruble. The Baltic States exited the ruble zone early and ultimately, pegging their new currencies. Estonia was the first to exit the ruble zone. The launching of an independent currency, the kroon, in 1992 coincided with the implementation of a radical reform program based on a currency board to fight high inflation inherited from the ruble area. The currency board imposed

[230] Author's interview with Karol Mrva, Member of the NBS Board, Executive Director Financial Market Operations, December 9, 2005, Bratislava.

a rigorous institutional and monetary policy framework that left little space for discretionary policy. The Bank of Estonia (BOE) was prohibited from lending to the government and short-term financing of commercial banks in order to avoid political pressures. The liberal foreign investment and trade regimes as well as the privatization of banks and enterprises on a cash-basis to foreign investors enabled the government to break decisively with the communist legacy and build a competitive financial system based on market-based bank-industry ties.[231] The rigid peg has enjoyed a broad political consensus, shared by the BOE and has had considerable public support from the beginning, bringing transparency and credibility to economic policies (Grigonyté 2003:116–119).

Lithuania pegged its new national currency, the litas, to the U.S. dollar in 1993, which was subsequently changed to a currency board in April 1994. Although the Lithuanian parliament had already passed a law in December 1991 on the national currency, political disagreements delayed exit from the ruble zone (Korhonen 1999: 17). The intention to introduce a currency board, announced by the Prime Minister at a press conference in October 1993, was followed by a clash of diverse economic, political, and ideological interests (Camard 1996). The idea of currency board was supported by the government (and the IMF) but it was opposed by the Bank of Lithuania (BOL), commercial banks, and many industrial enterprises. Banks were against the proposal because a currency board would have meant large profit losses by trading in foreign currency. The Federation of Industrialists wanted the exchange rate at a lower level to preserve the competitiveness of domestic exports (Aima 1998, Nenovsky, Hristov, and Mihaylov 2002: 11). A currency board was established in part

[231] Foreign ownership transferred the responsibility for lender of last resort operations to the bank shareholders (Wyplosz 1999: 18).

to prevent the kind of political interference with the BOL that led in 1993 to the dismissal of the bank governor and the board (Maxfield 1997: 59).[232]

The Latvian government chose to peg its new currency, the litas, to Special Drawing Rights of the IMF (SDR) in February 1994. Slower financial sector reforms and abuse by insiders led to the banking crisis in 1995. The largest Latvian bank, Banka Baltija, which held 30 percent of deposits, and fifteen other banks collapsed.[233] Insider lending was a prominent feature in most insolvent banks: bank managers, bank owners, and the state used bank resources to finance their own credits; however, there were other reasons for the Latvian banking crisis that differed from the other two Baltic states (Berensmann 2002: 220). Latvian banks profited from financing transit trade between the East and West from 1993 to 1994 because world prices for metal and other commodities were substantially higher than Russian prices. But when Russian prices increased to the level of world prices, the credit portfolios of banks deteriorated. Latvian banks were also used for Russian flight capital and money laundering (Berensmann 2002: 225). In fact, the role of interest groups has been much greater in Latvia than in Estonia, partly related, perhaps, to different economic structures, particularly the existence of larger industrial units with more political clout and the greater involvement of the ethnic Russian population in business activities in Latvia (Feldmann 2000: 18–19). After the banking crisis, the government accelerated liberalization and privatization of the financial and enterprise sectors. A crucial factor

[232] In contrast to Estonia, the institutional design of the Lithuanian currency board allowed the BOL to exercise the lender of last resort function when the banking sector threatened financial stability in 1995. During the Lithuanian banking crisis in 1995, the central bank provided liquidity support for a small bank (Aura Bank) that had been experiencing problems. When the largest private bank (Innovation Bank) and two other banks ran into difficulties, the Lithuanian parliament passed a law requiring the government to extend guarantees for interbank borrowing by struggling banks (Korhonen 1999: 27).

[233] Before closing Bank Baltija, the Latvian authorities tried to negotiate with bank management to prepare a restructuring plan. When these negotiations proceeded, bank managers were reportedly able to strip the bank of 260 million U.S. dollars of assets and transfer them to a Russian financial institution (Barisitz 2002: 94).

in Latvia's successful reforms was also the high independence of the Bank of Latvia, which had pursued a de facto peg since 1994 (Pomfret 2003: 601).

In spite of slightly different approaches to the initial choice of regimes and commitment to financial openness, all three Baltic countries were able to sustain fixed regimes throughout the transition, often in the face of large negative shocks, including banking crises, currency appreciation, voter backlash against reforms in Estonia, and so on. By instituting currency board rules, policymakers lost possibilities (and incentives) to exercise discretionary monetary policy to distribute rents to incumbent interests. Rigid pegs signaled a clear commitment to inflation stabilization and created confidence in commitment to financial openness and reform.[234]

While early peggers shared their commitment to disinflationary policies based on fixed regimes, they differed in their commitment to establish independent monetary authorities. Legislators in Estonia, Slovakia and the Czech Republic granted their central banks complete autonomy in monetary and exchange rate policies to "deflect political pressures," as the prime minister of Estonia put it (Laar 1994: 3). But Polish and Hungarian central banks had a legally stipulated role in supporting government economic objectives, and the governments have been assigned an important role in the exchange rate policy (Radzyner and Riesinger 1997). Therefore, exchange rate policy-making in these countries is based on a "consensus" between the central bank and government. So, when currencies of these countries started to appreciate in real terms under fixed regimes in conditions of residual inflation and increasing capital inflows, they switched to crawling pegs and crawling bands that served the dual objectives of maintaining competitiveness and moderating inflation (Frommel and Schobert 2006:

[234] The other difference between the Estonian and Lithuanian currency boards is that while Estonian law allows only the parliament to devalue currency, Lithuanian law gave this right first to the government and later to the BOL (Hansson 1997: 270).

468). The appreciation eroded competitiveness of tradable producers who became vocal critics of the monetary policy, leading to a deterioration of trade and current account balances and to the accumulation of foreign debt.[235] Crawling pegs have been considered to be an effective nominal exchange rate anchor in an inflation reduction program (Dornbusch and Werner 1994). In addition, the governments of both countries severely limited their ability to borrow from their central banks. These legal restraints on discretionary borrowing and open financial systems allowed Poland and Hungary to pursue sustainable exchange rate policies without financial turbulences.

After it left the Yugoslav monetary union, Macedonia also tried to regain stability by adopting an exchange rate peg but less decisively in the beginning than other early peggers. The disintegration of the Yugoslav monetary union that accompanied the break-up of the Yugoslav federation led to extremely high inflation in all its successor states, which was additionally fuelled by military conflicts, expansionary monetary and fiscal policies, and failed stabilizations.[236]

The Klusev's "government of experts"[237] in Macedonia, introduced its new currency, the denar, and the first stabilization package in April 1992 accompanied by the establishment of an independent central bank, National Bank of the Republic of Macedonia (NBRM), modeled upon the German Bundesbank (Bišev 2002: 272). Initially, inflation and repeated devaluations of the currency persisted because of the

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[235] For example, the President of the large Hungarian firm Videoton repeatedly criticized the monetary policy of the NBH for a large currency overvaluation (Bohle and Greskovits 2004: 21).

[236] Monetary policy was highly politicized and a major source of redistribution of income in the former Yugoslavia. The National Bank of Yugoslavia (NBY) allocated the credit to agriculture, exporters to the CMEA, and the Yugoslav National Army. It also assumed foreign exchange rate losses of SOBs (infamously known as a "black holes"): banks were liquid in foreign exchange but dependent on NBY for daily dinar liquidity needs, and NBY had to monetize foreign exchange flows. After yearly inflation breached a thousand percent, a stabilization program anchored to the Deutsche markwas announced in December 1989. But the stabilization was unsuccessful. Inflation accelerated in mid–1991, as NBY began printing money to finance war (Kraft 1995, Prašnikar, Jazbec, et al. 2002).

[237] There were only two politically affiliated ministers in the government.

pressure of agricultural producers for monetary expansion and easy credit (Kraft 1995: 485, Daviddi and Uvalic 2003). In autumn 1992 and December 1993, the government adopted two subsequent stabilization packages, sponsored by the IMF, which were successful at regaining monetary stability. Earlier, in June 1993, the Sobranie (the legislative body) enacted legislation to privatize banks together with enterprises under the general enterprise privatization scheme (but avoiding mass privatization) and strengthened the banking supervisory standards (Perry 1997: 263). By the end of 1995, more than 60 percent of the share capital of the four old banks was privately owned (Bisev 2002: 266), allowing the government in October 1995 to replace the flexible regime with a fixed regime to maintain price stability. Although the entry of foreign investors into the financial sector had been liberalized and macroeconomic policies were prudent, the ownership structure did not have substantial foreign participation until the end of 1999, mainly because of high political risk.[238] NBRM has retained its de facto peg to the Deutsche mark (the euro) since the early 1990s, and was able to withstand the 2001 ethnic and security crisis and other external shocks (Barisitz 2004 and 2007).[239]

In sum, not only did the fixed regime help to decrease inflation but the output loss of disinflation was lower in countries that have used it as the external anchor at the outset of the transition. An important advantage of a fixed regime was that it provided a highly visible and easily verifiable target and represented a rapid institutional fix for credibility problems of post-communist governments and central

[238] Between 1992–1996, Macedonia experienced a reversal in its democratization. After elections in 1994, opposition parties were excluded from the Parliament and society was controlled by the party in power with roots in the former *nomenklatura* (Drezov 2001: 417).

[239] The main external shocks that influenced the post-communist development in Macedonia include the unilateral Greek embargo on movement of trade of the two countries from April 1994 to November 1995, the Kosovo crisis in 1999, and the EU sanctions against the authoritarian regime of Slobodan Miloševic in Yugoslavia in 1999 (Bišev 2002).

banks. The fixed regime as a nominal anchor also helped to stabilize the budgetary cost of debt servicing in states with high external debt (such as Hungary and Poland) and worked as a disciplining device for domestic industries.

The Floaters: Clientelism and Fear of Pegging

Some societies whose fiscal and monetary authorities continued to pump funds to state-owned enterprises through SOBs were reluctant to adopt radical stabilization programs, including those based on a fixed exchange regime, and policies compatible with these regimes (table 5.2). The banking sector was the incipient and subject to intense political pressure for directed credit from enterprise lobbies and government ministries in control of ailing enterprises and economic sectors. Subordinate central banks were required to lend directly to government to finance fiscal deficits. Continued subsidies, directed credits, and bailouts to incumbent financial and industrial interests generated substantial pressure for inflationary monetary expansion, and challenged stabilization and institutional reforms.

The persisting linkages within the financial system (between state-owned and new crony private banks) and between banks and enterprises, as well as the linkages of these interest groups with the government allowed these groups to extract inefficiently large resources from the state. SOBs and enterprises in need of more intensive protection against foreign competition together with government politicians, benefiting from the links with these state monopolies, developed into a strong political force, capable of altering even the most committed anti-inflationary reform programs to retain their gains (Hellmann 1998).

Stabilization and financial reforms were delayed, allowing these states to preserve clientelistic financial systems characterized by rent-seeking and corruption.[240]

[240] On delayed reforms, see Alesina and Drazen (1991), Rodrik (1996).

Even when some of these countries during some periods officially announced fixing, they tended to float more than what they announced and frequently reneged on their commitment to a fixed regime. Their exchange rate strategies can be characterized as fear of pegging. This discrepancy between their official and actual exchange rate policies is best explained by Alesina and Wagner (2003), who show that when countries announce pegs and then break their commitments to pegs reflect weak institutions (corruption, weak protection of property rights, and so on) related to poor macroeconomic management to maintain monetary and fiscal stability. Flexible regimes led to postponement of privatization and banking reforms in EE.

Bulgaria and Romania initially adopted flexible exchange rate regimes despite being plagued by high inflation. After a few months of attempted stabilization in 1991–1992, their central banks repeatedly provided bailouts to SOBs and enterprises and monetized rapidly increased credit that led to further inflationary pressures (Berglof and Bolton 2002: 80). Bulgaria started with float and money-based stabilization but its de facto monetary policy was rather loose and accommodating, and this notably compromised the country's stabilization efforts (Dobrinsky 2000: 586).

The monetary policies of the National Bank of Romania (NBR) were often under intense political pressure to accelerate the nominal devaluation of the national currency in order to alleviate price competitiveness problems in industry, to finance deficit spending needs of the government, and to bail out failing SOBs repeatedly (Barisitz 2004: 108–110). To this end, the Parliament adopted a law obliging SOBs to provide loans to "strategic" sectors, such as agriculture and energy imports, and requiring the central bank to cover these loans. There has been strong political pressure placed on SOBs to sustain large state-owned companies. SOBs, in turn, expected government protection because bankruptcies were a politically unacceptable

solution. The government further rewarded SOBs by providing them with profit-making opportunities by issuing high yielding treasury bills (Doltu 2002: 288). In this highly inflationary environment, exporters started to hoard hard currency, which put additional pressure on the foreign exchange market and complicated stabilization policy (Daianu 1995: 218).

Although Albania initially attempted to officially peg its currency to the U.S. dollar in 1991, its stabilization program ended in failure and collapse of pegs because monetary policies continued to be a source of income redistribution. In July 1992, the Berisha regime adopted a managed float as a part of an IMF–supported stabilization program. The program required, among other things, free movement of the exchange rate and phasing out subsidies to failing enterprises (Pano 1997: 335).

As shown in the previous section, in the post-Soviet region, the Baltic states that were able to cut ties with incumbent interests and were interested in fast paced reforms, pegged to Western currencies to achieve and demonstrate a commitment to price stability from the early years of transition. Most CIS republics were not able to commit to the requirements associated with maintaining fixed regimes and floated their currencies after the disintegration of the ruble zone in 1993. Banking systems in most CIS states remained dominated by SOBs and discriminatory restrictions were imposed on foreign banks. It should be noted, though, that some CIS republics suffered from longer legacies of communism and more unfavorable initial conditions than countries in CEB (table 5.1). Belarus, Tajikistan, and Turkmenistan during the 1993–1995 period, and Ukraine and Russia during the 1995–1997 period officially announced pegs, but were not able to sustain them. Instead, they pursued de facto intermediate or flexible regimes, clearly demonstrating fear of pegging.

Leonid Kravchuk, Ukraine's first president, did not make a decisive break with the past; instead he continued in the Soviet-style economic micromanagement, while

Leonid Kuchma, the country's second president, delayed stabilization and financial reforms (Stone 2002: 169). In November 1992, Ukraine introduced a transitional currency, the karbovanets, to pursue a more inflationary monetary policy than was consistent with membership in the ruble zone, which allowed the government to subsidize domestic industries and agricultural producers (Petryk 2006). By May 1992, the National Bank of Ukraine (NBU) had already doubled the level of credit to state enterprises (Stone 2002: 173). As a result, in 1993–1994, Ukraine had the worst inflationary experience in the ex-Soviet Union: inflation peaked at more than 10 thousand percent and led to the biggest economic downturn in the history of the country with 23 percent decrease in real GDP (Petryk 2006).

Victor Yushchenko, who was appointed the governor of the NBU in 1993, tightened monetary policy. Stabilization started for the first time at the end of 1993 with setting a narrow corridor for the exchange rate of the coupon-karbovanets against the U.S. dollar. The NBU replaced the two-tiered exchange rate system, used to subsidize imports by state enterprises with a unified exchange rate, as well as the corrupted foreign currency rationing system with a system of open currency auction.[241] Importantly, the NBU imposed credit ceilings on individual banks and abolished the practice of refinancing banks at preferential interest rates (Stone 2002: 177–178). During the monetary reform of 1996, the temporary currency was exchanged for a more permanent currency, the hryvnia, at the rate of 100,000:1. But the NBU continued to extend directed credits to agriculture and energy lobbies. In order to stabilize the new currency, the exchange rate began as a nominal anchor for the fight against inflation, which was the condition of the IMF Standby Program

[241] Previously, there were at least four exchange rates in Ukraine: the central bank official exchange rate, the auction rate, the commercial rate of cash purchase-sale, and the black market exchange rate.

(Stone 2002: 183). Nonetheless, financial reforms were hindered by insider privatization of banks, discussed in chapter 3.

In Tajikistan, the civil war of 1992–1993 and in 1996–1997 dominated political developments. The war delayed until May 1995 the country's exit from the ruble zone and implementation of consistent economic reforms.[242] The availability of exportable energy resources in Azerbaijan and Turkmenistan may have allowed the governments to delay radical reforms because of high levels of rent-seeking in these oil producing countries (De Melo et al 2001, Hefeker 1997) (table 5.1). Delayed privatization and banking system reforms in these countries allowed incumbent banks and industries to extract large resources inefficiently from their governments. Uzbekistan is one of the least reformed transition economies; it had never committed to an anti-inflationary program based on a fixed exchange rate, and it only succeeded lowering the inflation rate below 50 percent in 1998 (Pomfret 2006). Domestic banks continue rolling over loans to enterprises on non-commercial principles because they operate under government guarantees (Spechler 2004). Uzbekistan maintained a system of multiple exchange rates, including a black-market price and foreign-exchange controls.

Similarly, Belarus under the authoritarianism of President Alyaksandr Lukashenka—that Taras Kuzio (2003) called a "neo-Soviet with a little goulash communism"—pursued de facto flexible regimes. Most stabilization and banking reforms are still before its government. The central bank is completely dependent on the President who issued a Decree in March 1998, transferring the responsibility for monetary policy to the government. Most of the country's productive capacity remained in state hands, making it the most unsuccessful case of privatization in EE

[242] Although Tajikistan had a de facto separate currency after November 1993, the ruble was used and its central bank did not control monetary policy (Pomfret 2006: 6). See, also Abdelal (2001).

(Kaltenhaler, Ceccoli, and Michta 2006). In 1996, the private sector accounted for only 15 percent. The government artificially maintained the overvalued Belarusian ruble against the U.S. dollar and imposed restrictions on the foreign-exchange market. The IMF and foreign investors, worried about the halt of the privatization process in the second half of 1996, have largely withdrawn from the country (Gurushina, Wyzan, and Slay 1997).

Georgia's delayed reforms, civil unrest, and warfare in 1992–1993 resulted in hyperinflation, extreme currency substitution, and repeated devaluations.[243] After the introduction of the surrogate currency in April 1993, monetary and credit policies were excessively accommodative and repeatedly subject to direct intervention of the government and parliament. The Law on the National Bank of Georgia (NBG) did not provide for the bank's independence from the government. NBG remained closely involved in operating the Savings Bank and other former specialized banks and was required to provide credit to the government. In fact, in 1992–1993, the government deficit was almost entirely financed by the central bank (Gurgenidze 1995: 199).

The Georgian banking system remained dominated by five large SOBs continuously bailed out by the government.[244] Weak banking regulation, lenient licensing procedures, and low minimum capital requirements led to a rapid proliferation of "quasi-private" banks founded by state enterprises, primarily to obtain cheap financing for their shareholders. Despite negative lending rates in real terms, banks became one of the most profitable industries in Georgia through maintaining high spreads on their retail banking activities (Gurgenidze 1995: 203–209). Thus, a

[243] The conflict in Abkhazia and with the supporters of ex-President Gamsakhudia resulted in a drastic fall in output, but inflation did not reach the hyperinflationary level until after the introduction of the coupon in 1993 (Wang 1999: 4).

[244] As early as 1991, two SOBs, Agroprombank and Industriyabank, had serious bad loan problems and were bailed out by the government at a cost about 1.8 billion U.S. dollars (Gurgenidze 1995: 208).

flexible regime was adopted almost by default because the government was unwilling to commit to policies compatible with a sustainable peg. In 1995, the government finally adopted the IMF-supported stabilization program to stop hyperinflation. However, the government continued to use a flexible regime, arguing that regime flexibility is needed to allow financing of its operations by NBG and to generate seignorage-related revenues (Wang 1999: 9).[245] The stabilization program helped to halt hyperinflation and allowed the government to introduce a new national currency, the lari. Nonetheless, while the NBG stopped providing credit to the banks and economic sectors, it continued to finance the government.

The Cost of Clientelism: Banking Crises and Failed Regimes

The choice of exchange rate regime plays a crucial role in macroeconomic stabilization in the short term. In the medium-term, policymakers need to devise and implement a policy mix, which is consistent with the chosen regime. Fixed regimes and currency boards have increased the credibility of central banks and economic policies by limiting the discretionary powers of monetary authorities. Pegging required a certain degree of commitment from the monetary authority and the government to pursue policies compatible with this regime. Tightening monetary policy itself did not prevent banks from supporting state enterprises. It was crucial that peggers observed the rules of the game inherent in this exchange rate strategy including constraining an activist monetary policy and implementing financial institutional reforms. Fixed regimes required sound financial systems.

[245] In the context of the stabilization program, there was a discussion on the choice of exchange rate regime. Some advocated a currency board to provide an anchor to the financial system and credibility of the program. But the float proponents prevailed (Wang 1999: 9).

In societies where central banks remained subordinate, they were compelled to monetize loses incurred by enterprises, government, and banks.[246] When the banking sector remained dominated by incumbent banks, weakly capitalized or insufficiently supervised capital flows led to systemic banking crises and currency collapses. The governments that were not able to commit to prudent fiscal policy and to conduct financial reforms, including privatization of SOBs to outsiders, were forced to abandon the chosen exchange rate regime, often after costly financial crises. Thus, exchange rate regime changes in EE were the results of a deliberate strategy, but were also associated with banking and currency crises that brought about forced regime changes.

A fixed exchange rate regime persisted for more than six years in the Czech Republic. It was considered a symbol of Czech success (Horváth 1999: 277). However, the economy has encountered extensive problems due to the lagging reforms in the financial sector relative to progress in privatization in trade and foreign exchange. Voucher privatization led to opaque governance structures in both the enterprise and banking sectors, and created new opportunities for corruption by the four largest SOBs through managing voucher privatization funds. The Klaus government's protective bank policy and a loosening of fiscal constraints were at odds with the fixed regime requirement and clashed with the anti-inflationary policy of the independent Czech National Bank (CNB). The policy slippages of the Czech government in the mid-1990s were instrumental in forcing CNB to abandon the peg in 1997 under extreme market pressures, which involved the rising shares of bad loans, a banking crisis, and an attack on the currency. The collapse of the peg resulted from economic policies that were inconsistent with a fixed regime (Backé 1999).

[246] Banks in EE did not support independent central banks, for central banks took an active role in financial system reforms that placed constraints on commercial bank behavior (Johnson 2006).

In Slovakia, as a result of insider privatization that virtually excluded foreigners and expansive fiscal policy under the third Mečiar administration (1995–1998), the NBS was forced to abandon a fixed regime in October 1998.[247] The government's expansive policy had generated unsustainably high current account deficits financed by external borrowing.[248] In its privatization policy, the government adopted a law on barring the sale of strategic enterprises, including the three largest SOBs and measures that privileged domestic applicants over foreign applicants in the privatization process with the aim of establishing a "domestic entrepreneur class" capable of sustaining Slovak independence.[249] The privatization of banks and access to financing became a means to reward political loyalists who were large corporate patrons, which contributed to an increase in inter-enterprise debt and bad loans.[250]

NBS followed a strict anti-inflationary program to counter the government's fiscal laxity and to communicate its position to the government.[251] NBS resisted pressure from the government and the financial and industrial sectors for financial laxity. It tried to prevent attacks on the currency by suspending the refinancing of the

[247] The objectives of the 1995 Program Declaration of the Government deviated from the original transformation program in three areas: first, intention to shift from restrictive to expansive financial policy; second, active sectoral industrial policy; and third, major changes in the area of privatization.

[248] Author's interview with Juraj Renčko, former Advisor to the Minister of Finance and the Head of the Coordination Unit for Bank and Enterprise Restructuring and Privatization (1999–2002), December 6, 2005, Bratislava.

[249] For example, in 1995, out of 367 privatization decisions, only 5 favored foreign applicants. In 1996, foreign investors won only 2 out of 400 decisions (Mikloš 1997).

[250] VSŽ (Východoslovenské železiarne), the largest Slovak steel producer and exporter first acquired a large share of its creditor bank—the Investment and Development Bank—to finance its expansion plans in enterprises in spite of the disapproval of NBS and the criticism of the IMF. Later, it replaced all but one of the bank's Board of Directors, resulting in a near bank failure. Author's interview with Ladislav Vaškovič, CEO of EXIMBANKA, former Chairman of the Board of VUB, December 12, 2005, Bratislava. Also, Mikloš (1997: 72).

[251] Author's interview with Elena Kohútiková, Vicegovernor of the NBS (2000–2006), December 6, 2005, Bratislava.

financial sector in 1997 in spite of strong bank opposition.[252] The behavior of NBS fuelled growing tensions with the government and industrial leaders, resulting in government attempts to limit the independence of NBS in early 1998 by proposing a controversial draft amendment to the central bank law, which would have increased its participation in the short-term covering of the state budget deficit. Nonetheless, given NBS's reputation as a pillar of macroeconomic stability, the government was forced by the threat of a loss of domestic and international confidence to retreat from plans to curtail its independence (Dvorsky 2000: 20).[253]

In both the Slovak and Czech Republics, the central banks were able to detach themselves from established interest groups and conduct a price-stabilizing monetary policy based on exchange rate fixing. However, their policies conflicted with that of the governments, which were unwilling to impose hard budget constraints on domestic banks and prevented opening their banking system to foreign buyouts. Both central banks tried to prevent currency devaluations but were not able to defend pegs. It was frustrating for the leadership of the NBS to deal with this unsustainable economic policy mix, as the former Vice governor of the NBS explains:[254]

> The Mečiar government provided guarantees and privatized to people without capital. The NBS had to pursue restrictive monetary policy to compensate for bad economic policies. This caused interest rates to rise sharply, with rates on new loans peaking at over 20 percent in fall 1998. The exchange rate band was gradually widening. Expectations of upcoming elections were looming. In

[252] Author's interview with Peter Ševčovic, Member of the Bank Board of the NBS, December 2005, Bratislava.

[253] I examine the international influences in transition in Slovakia in a companion paper: Jana Grittersova, "Carrots, Sticks, and Nationalism: International Dimension of Democratization in Slovakia and Croatia," mimeo.

[254] Author's interview with Elena Kohútiková, Vicegovernor of NBS (2000–2006), December 6, 2005, Bratislava.

> September [1998] the NBS tried to defend the peg by massive interventions on international markets. But the government generated a double deficit. Right after the elections the koruna was devalued.

Currency crashes in EE have occurred not only under standard fixed regimes but also under flexible regimes as demonstrated by repeated currency crises in Bulgaria, Romania, and Albania. A protracted period of sluggish reforms and the reluctance of the governments of those countries to privatize banks threatened the stability of their financial systems and led to a financial and economic crisis in the late 1990s. In all three countries, financial crises contributed to political upheaval and changes of government. In extreme cases of rent-seeking interest groups, weak governments, and captured central banks leading to banking crises and currency collapses, currency boards were installed (as in Bulgaria and Bosnia) to tie the hands of government.

In Bulgaria, seven consecutive governments of ex-communist Bulgarian Socialist Party (BSP) and the opposition United Democratic Front (UDF) during 1990–1996 proved unable to commit to bank stabilization and privatization. Only hyperinflation and a banking and financial crisis in 1997 led to the adoption of a radical stabilization program (supported by the IMF) and opening the banking system to foreigners. The program also replaced the discredited inflationary and discretionary central bank by a Deutsche mark currency board in July 1997.

Romania and Albania also witnessed devastating banking and financial crises primarily because of the collapse of a number of fraudulent pyramids (*Ponzi* schemes) around a small number of domestic banks (Berglof and Bolton 2002: 85). Weak financial regulation allowed the proliferation of quasi-banks (so-called cooperatives), unregulated by the NBR from 1997. These banks engaged in aggressive speculation on the financial markets that resulted in liquidity problems in these institutions and in a

systemic banking crisis in 1999 (Doltu 2002: 290). President Iliescu and the ruling party were defeated and a transfer of power took place. After the crisis, the new government abolished administrative controls over the official exchange rate but continued a free float policy. The float complicated the task of NBR, whose credibility remained weak, to bring down inflation, which remained at two-digit levels until the end of 2004 (Crespo-Cuaresma 2005: 847–848). Nevertheless, the government has recently launched the privatization of two major SOBs.[255] The financial sector reforms have recently been accompanied by a fairly stable real effective exchange rate. Similarly, in Albania, speculative behavior of crony pseudo-banks, which offered astronomical interest rates, led to a devastating banking crisis.

The 1998 Russian financial crisis generated in other EE economies, to a varying degree, capital outflows leading to exchange rate and equity market pressures and higher interest rates (Backé 1999: 51). The crisis also generated the CIS area-wide currency devaluations. Most CIS countries then moved to floats that allowed them to postpone financial reforms even further.[256] Kazakhstan was the hardest hit by the Russian crisis. In fact, Kazakhstan's economic system resembles Russian capitalism in its concentration of economic power and corrupted privatization policies that favor domestic energy and mineral producers (Pomfret 2006: 6–7).

The Ukrainian financial crisis in 1998 had similar root causes as did the Russian one but was less dramatic with smaller depreciation effects because the Ukrainian banks had no large foreign loan exposures. The reform-oriented, if short-lived Yushenko government came to power in December 1999. It renewed

[255] Romanian Bank for Development and BancPost.

[256] Currently, the CIS zone may be characterized as the "U.S. dollar zone" because its members depend on exports of commodities, which are quoted in U.S. dollars. CIS countries also launched discussions to form a monetary union among themselves (Vinhas de Souza 2005: 422).

stabilization efforts, strengthened the powers of the NBU, and initiated banking reform, but it was voted out of office in April 2001 by a political coalition of business oligarchs and communists.[257] However, the new government remained committed to the policy of its predecessor and decided to pursue the de facto exchange rate peg based on the U.S. dollar to stabilize inflationary expectations (Van Aarle, de Jong and Sosoian 2006).

Fear of Floating: From Clientelism to Financial Openness

After the painful learning experiences with failed pegs, some societies opened their banking systems to foreign competition, built strong institutions of financial governance (better protection of property rights, stricter banking regulation), and replaced clientelistic systems with open financial systems. Although they were forced officially to abandon fixed regimes, their central banks managed the exchange rate to a greater extent than announced. These societies have pursued fear of floating policies. Their strategy of pursuing stable exchange rates signals credibility to international markets while high exchange rate volatility and devaluation are perceived as an indication of weak economic management and institutions (Alesina and Wagner 2003).

The situation in Croatia during the second half of the 1990s is often cited as a classic example of the fear of floating. The Croatian Democratic Union–led government under President Tudjman established a new central bank, Croatian National Bank, solely responsible to parliament, and tried to stabilize the economy through a restrictive monetary policy and a peg of temporary currency to the Deutsche mark in December 1991. Nonetheless, inflationary pressure rose again in 1992–1993 because the government financed its expenditure via an inflation tax. The central bank

[257] The NBU was able to overcome political barriers and decided to liquidate the large government bank—Bank Ukraine—that focused on agriculture and practiced insider-lending (Barisitz 2006).

continued to service large loss-making enterprises and provided soft credits to agricultural lobbies and the shipbuilding industry (Kraft 1995).[258] The average annual inflation rate in September 1993 over 1,500 percent forced the government to adopt a new stabilization program in October 1993 based on managed float and grant the central bank independence (Daviddi and Uvalic 2003). The program put inflation under control and the government successfully introduced a new currency, the kuna, in May 1994. After unsuccessful enterprise privatization, the government launched successful privatization of socially-owned banks to foreign investors. It also introduced a new banking law that strictly regulates the susceptibility of banks to the influence of well-connected interest groups.[259] These policies allowed the Croatian central bank to pursue officially tightly managed float that actually resembles a fixed regime. Because the large share of Croatian's liabilities is made up of foreign currency, the stability of the national currency is crucial for the stability of the banking sector (Barisitz 2004: 103–104).[260]

The Czech and Slovak republics officially adopted flexible regimes (in combination with inflation targeting) after their pegs collapsed in 1997 and 1998. After currency collapses, new governments in both countries launched ambitious bank privatization programs and opened the door to foreign investors.[261] Open financial

[258] In 1992, the Croatian government also put pressure on the governor of the central bank, demanding a loan with a maturity of ten years and an interest rate below the inflation rate (Dvorsky 2004: 72).

[259] The impact of enterprise privatization in the first half of the 1990s resulted in those associated with the ruling party of President Tudjman controlling socially owned assets, including rich expatriates from the Croatian Diaspora who helped to finance Tudjman's 1990 victory and the managers of the socially-owned enterprises who profited from management buyout loan schemes (Cohen 1997).

[260] There is a high level of euroization in Croatia: about two-thirds of loans and deposits is denominated in, or indexed to, a foreign currency (Barisitz 2007: 85). The high degree of euroization originates in the war period of the early 1990s, when foreign currency was used as a means of payment (Crespo-Cuaresma et al 2005: 848).

[261] Initially, the first Dzurinda government (1998–2002) was unable to adopt decisive measures to stabilize the economy and privatize banks and industries. This indecisiveness brought the country to the brink of a financial crisis in May 1999, which was a turning point in government policies. Author's

systems allowed their central banks to pursue stable exchange rates by systematically intervening in foreign exchange markets.[262]

Since the mid–1990s, some CIS republics pursued de facto pegs to the U.S. dollar (either directly or via a ruble target) although they continued to float their exchange rates officially. Armenia introduced its own national currency, the dram, in November 1993 and implemented a stabilization program, backed by an IMF agreement. The program drastically reduced hyperinflation. Stabilization was accompanied in 1994 by a large scale privatization program, tightened banking regulation, and a liberal policy toward foreign investments aimed at attracting investors.[263] The main policy objective of the Central Bank of the Republic of Armenia (CBRA) under Governor Tigran Sarkisyan was macroeconomic stability to create favorable conditions for the private sector.[264] While CBRA officially claimed to pursue a float, partly to reduce the level of dollarization in the country, it manages the exchange rate to a greater extent than announced. CBRA has proven its independence when, in spite of public pressure from exporters, it refused to intervene when the currency started to rapidly appreciate against the U.S. dollar in 2003 due to an increase in private remittances (Danielyan 2005).

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interview with Juraj Renčko, former Advisor to the Minister of Finance and Head of the Coordination Unit for Bank and Enterprise Restructuring and Privatization (1999–2002), December 6, 2005, Bratislava.

[262] After adopting a float, NBS continued to intervene when the exchange rate volatility exceeded one percent. Author's interview with Peter Ševčovic, Member of the Bank Board of the NBS, December 14, 2005, Bratislava. The Monetary Program of the NBS for the year 2000 stated: "When NBS expects appreciation pressures, it is ready to intervene … the intent of NBS will be to stabilize the foreign exchange rate approximately at the current level. CNB also tried to limit exchange rate volatility after it officially proclaimed float, and its interventions during 1998–2000 were clearly the sign of fear of floating. Author's interview with Miroslav Hrnčíř, Advisor to the Governor of CNB, June 7, 2006, Prague.

[263] By 1999, the only SOB that remained to be privatized was the Savings Bank. "Armenia: A special Report" prepared by Euromoney. London, Paril 1997.

[264] See "Armenian Central Bank head says policies will be more predictable," BBC Monitoring Former Soviet Union-Economic, September 11, 1999.

Kyrgyz President Askar Akaev introduced a new currency, the som, to gain control over monetary policy and to reduce inflation, as part of sweeping stabilization and liberalization reforms designed by the IMF in May 1993 (Abdelal 2001: 50). Kyrgyzstan was the first Central Asian republic to succeed in decreasing inflation bellow 50 percent in 1995. The government also pursued privatization with the greatest vigor of any country in the CIS region, made substantial progress in adopting modern central bank legislation, and allowed widespread foreign penetration into the country's banking sector (Lybek 1999, Gurushina, Wyzan and Slay 1997). Kyrgyzstan also refrained from giving direct credit to government and strengthened banking regulation, allowing its central bank to pursue de facto fixed regimes in recent years.

Russia: Oligarchic Capitalism in One Country?[265]

Russia is a unique case since it emerged as a political, economic and military hegemon in the CIS region and was the core of the ruble zone. Russia itself dissolved the currency union in 1993 in spite of previous attempts to hold it together (Abdelal 2001: 46). The Russian financial system has also developed unique features and players: financial oligarchs. In 1992, President Yeltsin decided to adopt the same shock therapy program as in Poland, initially supported by fairly restrictive monetary policy. The stabilization program was implemented by Prime Minister Yegor Gaidar's reform team.[266] However, in contrast to other early stabilizers, in exchange rate policy,

[265] I borrow the term from Dani Rodrik's weblog http://rodrik.typepad.com/dani_rodriks_weblog/2007/04/oligarchic_capi.html. For a more detailed analysis of the role of financiers in exchange rate policies in Russia see a companion paper: Jana Grittersova. "Financial Architecture in Transition: Russia, the Czech Republic, and Poland," mimeo.

[266] The actual policies of many reformers, such as Leszek Balcerowicz, Yegor Gaidar, and Václav Klaus, were, however, often much less radical than their rhetoric. Most EE countries combined both reform strategies, and the shock therapy approach was only really applied in the former GDR (Gomulka 2000).

the Russian government did not commit to a fixed regime.[267] Moreover, the Central Bank of Russia (CBR) under Governor Victor Gerashchenko systematically undermined the government's attempt to stabilize the economy by increasing the money supply (Berglof and Bolton 2002: 79).[268]

During the first years of the post-communist stabilization in Russia, the positional rents of incumbent banks facilitated their co-optation as the major stakeholders in the government's hyperinflationary policy through maintaining artificially high interest rates on treasury bills, which offered banks huge speculative opportunities (Shleifer and Treisman 2000). An anti-inflationary stabilization program based on a fixed exchange rate was therefore an undesirable option for banks Banks actively lobbied against the central bank's attempts to tighten monetary policy from 1992 through 1994 (Treisman 1998, Gross and Steinherr 2004).[269]

Russian banks significantly influenced the ability of the Russian government to sustain a fixed regime. During the Yeltsin era, banks played a particularly important role, because in the absence of support from a political party and opposition from the Russian Duma, the president was dependent on their support (Gnezditskaia 2005: 465). The withdrawal of the state from the banking sector was inconsistent and limited in scope. The state foreign trade bank (Vneshtorgbank) and the state savings bank (Sberbank) remained under state control, and former specialized banks that financed selected companies during communism were transformed into "channel banks" and

[267] Interestingly, John Maynard Keynes helped to establish a currency board in Northern Russian in 1918, in the middle of World War I and the Russian Revolution. It functioned well for two years until the Bolsheviks abolished it (Boyden 1993: 11).

[268] The growing opposition to the Gaidar program forced the resignation of the previous governor of CBR and his replacement by Gerashchenko. Jeffrey Sachs famously called Gerashchenko "the world's worst central banker" (Adolph 2004: 119).

[269] For an examination of financial system development and exchange rate policies in Russia, see a companion paper: Jana Grittersova (2007). "Financial Architecture in Transition: Russia, the Czech Republic, and Poland," mimeo.

continued to distribute credit to selected sectors (Popov 1999: 15). As chapter 3 illustrates, loans for shares privatization was pivotal in the transition to the so-called "oligarchic capitalism," which allowed "oligarchic" banks to capture industrial producers and create financial-industrial groups.[270]

When inflation rose to about 150 percent in 1995, the government finally adopted a peg of the ruble to the U.S. dollar, aimed at disinflation as part of the new stabilization program for the period 1995–1997 (Rutland 2001). The introduction of a ruble corridor zone meant the loss of the most lucrative arbitrage opportunities of Russian banks on international financial markets.[271] The government compensated banks by high yielding federal government securities (*gosudarstvennye kratkosrochnye obligatsii*, or GKOs) and interbank credit markets (Hellmann 1995). Because banks were not more able to profit from lending to the government at high interest rates, they changed their monetary preferences in favor of a restrictive monetary policy of high interest rates combined with a fixed regime (Havrylyshyn and Odling-Smee 2000: 9). At that time, banks became strong opponents of devaluation, for by mid-1998, they had unbalanced sheets with 20 billion dollar liabilities and only 12 billion dollars foreign assets because of their speculations with GKOs (Woodruff 2005, Gros and Steinherr 2004: 35). Russian problems with the economic fundamentals appeared in 1997 but the CBR intervened to support the currency through higher interest rates because it was not willing to sacrifice the interests of banks (Woodruff 2005). These interventions resulted in huge losses of CBR's foreign exchange reserves.[272] Banks were parasites on the Russian state, draining state assets

[270] Author's discussion with Peter Rutland, March 17, 2006, Berkeley, CA.

[271] In July 1995, the CBR under interim governor Tatyana Paramonova announced its intention to stabilize the ruble zone within a band of 4,300-4,900 rubles to the U.S. dollar through October 1995.

[272] The CBR lost over 40 percent of its international reserves (6.5 billion U.S. dollars) in May 1998 alone.

and revenues that led to the unsustainable budget deficit, delayed devaluation of the ruble, and helped to trigger the 1998 financial crisis. The Russian crisis was a full-blown financial crisis with currency, debt, banking and stock market crises.[273] In September 1998, Russia finally abandoned the exchange rate band and introduced a float (IMF 1999). The tenacity with which Russia resisted a timely devaluation of the ruble and an exit from its currency peg before the financial crash in 1998 can be explained, in part, by the pressures of banks with large foreign currency-denominated debt on the government to maintain a fixed exchange rate (Woodruff 2005). Critics pointed out that a costly collapse of currency could have been avoided if the Russian central bank had been willing to sacrifice the interests of domestic banks and exit the peg earlier (Stone 2002). An interesting feature of crisis resolution was that the government abstained from substantial reform and opening of the banking sector. Quite the contrary, the share of SOBs in total assets even expanded after 1998.

Two Possible Outliers: Slovenia and Azerbaijan

The exchange rate strategies of Slovenia do not seem to be very comprehensive in terms of my finance-based hypothesis. The country started the transition with negligible foreign exchange reserves, almost forty percent of the banking sector insolvent, and a high inflation legacy. The Slovenian government adopted a gradual approach to stabilization based on a managed float.[274] And yet, the Slovene case offers one of the best examples of successful reform policies. The Bank of Slovenia (BOS) strongly committed to fight inflation, intervened heavily in the foreign exchange market. For the most of the transition period, BOS was able to

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[273] Among the major causes of the banking crisis were foreign exchange exposures and bad lending with limited risk diversification.

[274] Inflation was reduced to 5-6 percent month by April 1992 and reached 2 percent in July 1992.

maintain little nominal volatility of the Slovenian tollar until the country adopted the euro in January 2007.

An announced float allowed the BOS the room to engage in activist demand management. In Slovenia, the socialist regime was perceived to be homegrown, and thus was less discredited than in many other EE states (Feldman 2006). The government protected domestic industries and refused the IMF-sponsored proposals for rapid privatization of socially-owned enterprises and banks.[275] It was reluctant to let foreigners in to take over domestic banks and to allow direct foreign ownership, a sentiment also reflected in the banking industry. The government was particularly reluctant to privatize the two largest banks (White 2000).[276] It began to liberalize the banking sector substantially and dismantle barriers to foreign entry only in 1999 under strong EU pressure (Lindstrom 2005).[277]

How do we explain the successful monetary and exchange rate stability in Slovenia in spite of its slothful pace of privatization? One explanation stresses a remarkable degree of independence, with which the BOS was endowed from the beginning. The BOS was prohibited from extending a loan to the government for more than 5 percent of the budget.[278] Both monetary and fiscal policies supported stabilization. The other potential explanation may be that the influence of the "soft

[275] In 1992, Jeffrey Sachs proposed to the Slovenian government an IMF-endorsed plan for rapid privatization. The deputy prime minister Joze Mencinger submitted his resignation as a sign of his opposition to the plan. Prime Minister Alojz Peterle supported the dissenting "native" and rebuffed Sachs' blueprint for privatization (Ganev 2005: 369).

[276] The two largest SOBs are Nova Lubljanska Banka and Nova Kreditna Banka Maribor.

[277] A similar situation existed in the enterprise sector. It was not until 1994 that privatization began and by June 1995, only 200 of the 1,500 socially-owned enterprises selected for privatization had been privatized (Ramet 1997: 210).

[278] Some argue that BOS was able to maintain stable currency because it applied quite a restrictive stance with regard to capital flows, in contrast to other CEB states that liberalized their capital accounts relatively early. Capital controls in Slovenia were reintroduced in 1995 and 1997 (de Mello et al 2001: 105).

money" coalition of domestic banks and industries was limited by focusing their attention to the possibilities of enrichment via insider privatization, instead of inflationary credit policies (Kraft 1995).

The case of Azerbaijan is even more puzzling, for it has one of the highest government involvements in private business (Laurila and Singh 2000: 36).[279] Although the official regime is a float, in practice the National Bank of Azerbaijan (NBA) has used substantial reserves to keep the manat stable since the mid-1990s when the government launched the IMF-designed stabilization program to reduce inflation. Thus, in practice, the exchange rate resembled a fixed regime. Although the NBA is officially directly accountable to parliament and relatively independent from the government, in practice it operated under the tight scrutiny of President Heydar Aliyev (elected in 1993 and re-elected in 1998) known for its "patriarchal approach" to ruling the country (Laurila and Singh 2000: 39). Bank privatization and institutional reforms were delayed and the government imposed several restrictions on foreign bank entry like putting a 30 percent ceiling on foreign capital (Laurila and Singh 2000: 40).[280] But in contrast to countries with a similar clientelistic system of finance, the government's need for raising deficit financing was reduced because it raised revenues from oil-production sharing contracts.

The economy of Azerbaijan has some specific features that may help explain the government's exchange rate policy-making: first, its industrial structure is dominated by the oil industry and strong inflows of oil-related export earnings helped

[279] The EBRD Transition Report 1999 also ranked Azerbaijan as the most corrupt country in EE.

[280] The government only merged three SOBs—Prominvest Bank, Agroprom Bank and Savings Bank—into a single new bank, the United Universal Bank. The largest bank, International Bank of Azerbaijan, is still in state hands.

the NBA to rebuild reserves and defend the currency parity;[281] second, a large share of barter trade-transactions; and finally, a persisting lack of trust in the banking system that leaves large amounts of money outside of banks (Singh and Laurila 1999).

Consequently, there is little in this study's analytical framework that can explain why the Slovenian or Azeri governments were able to pursue a policy of de facto pegs (though officially floating) with financial sectors that remained dominated by SOBs and closed to foreign investors throughout most of the transition period. Slovenia was also one of the few countries without a banking crisis in the 1990s and was the first to enter the European Monetary Union (EMU).

Alternate Explanations and Conclusion

As I demonstrated in this chapter, exchange rate strategies in EE states are diverse, ranging from free floats to currency boards. Choices of anchor currencies have also varied. Progress in disinflation has been stronger in countries operating under a fixed regime (table A.5). This chapter is not intended as a strong test of the argument laid in chapters 2 and 3. Nevertheless, data on cross-country variation in exchange rate regimes in post-socialist societies are consistent with the argument at its broadest level. This variation in regime choices is consistent with the variation in stabilization and bank reform approaches adopted by governments to build financial systems. There are still large, though declining discrepancies between official and actual exchange rate regimes, reflecting the ability and willingness of EE governments to pursue policies compatible with sustainable fixed regimes.

As we saw in chapter 1, although existing approaches provide important insights into some aspects of exchange rate policies in EE, they cannot account for the wide variation in financial development and exchange rate strategies in the post-

[281] The manat remained the only CIS currency immune to the Russian crisis. See EBRD Transition Report 1999.

communist region. Among the alternative explanations, the credibility-related explanations pose the greatest difficulty for the theory I advance, because this argument was important in EE, particularly in the early years of transition, when price liberalization and the elimination of monetary overhangs inherited from the past resulted in high inflation. Some countries adopted fixed regimes for credibility purposes in the form of exchange-rate-based stabilization programs. A fixed regime was expected to anchor inflation expectations for price-and-wage setters and help to deal with the problems related to underdeveloped foreign exchange markets (Nehrlich 2002). And yet many states opted for flexible regimes initially, despite being plagued by high inflation and lacking credible monetary institutions.

An extension of this explanation is that the rise of democracy in EE societies was accompanied by the consolidation of interest groups. Distributional conflicts may have increased the government incentives to follow short-term policies to obtain political legitimacy, and decreased their willingness or ability to maintain credible exchange rate commitments. While this explanation may offer some insight into the exchange rate strategies of some leading countries in democratization like Poland, other countries scoring equally high on democracy did not move gradually toward more flexible regimes as democratic consolidation progressed but were forced to abandon pegs because of financial turbulence as was experienced in the Czech Republic.

The challenging question concerns how and to what extent various interest groups and economic sectors shape changing the preferences of politicians with regard to exchange rate policies in EE states. The underlying premise of Frieden's (1991) sectoral argument is that *asset specificity* of a sector and its industrial organization determine the incentives and capacity to lobby the government successfully for desired

economic policies.[282] Enterprises with very specific investments would want to protect themselves from foreign competition, and thus should be more likely to lobby.

That is not what happened in EE. At the outset of transition, the industrial landscape in most EE countries was dominated by the powerful industrial lobbies in the heavily subsidized and non-competitive manufacturing sectors that survived the breakdown of communism. When EE governments opened their markets, these industries were facing competitive international pressure to adjust. Because most of these manufacturers had high asset and factor inflexibility, their "exit" to another product or industry would have been costly in the short and medium terms (Hirschman 1986). In the light of the sectoral literature, we would thus expect them to lobby for state support in the form of subsidies or competitive exchange rates. Moreover, old state monopolies enjoyed low costs of political organization because they had large scale productive units and were regionally concentrated. Because they were large firms, they may have been successful in lobbying, independent of asset specificity (Alt et al. 1999). Many of these large industries were also the leading tradable sectors[283] that have enjoyed a privileged status derived directly from the state's own interests that depend on the profitability of the leading sector to assure export earnings and state revenues, in accordance with Shafer's (1994) argument.

First, the fact that there was a little variation in asset specificity and organizational characteristics of domestic producers in EE states at the outset of transition and yet diverse exchange rate policies, calls into question the utility of pure sectoral arguments. Second, large tradable producers in EE states have had obviously

[282] Excluded are alternative uses for the resources invested in lobbying and decisions by other enterprises harmed by one firm's lobbying activities. The assumption here is that firms are pre-existing organizations and do not have to solve internal collective action problem. See Alt et al. (1999).

[283] The leading sectors in CEB states were incorporated in the transnational system of production as export platforms with a EU destination (Bohle and Greskovits 2004).

powerful incentives and power to lobby successfully for competitive exchange rates. The real exchange rate appreciation of most EE currencies should have spurred their competitiveness concerns and pressure for a relatively weak currency and monetary autonomy, allowing government interventions on the foreign exchange market.[284] Nonetheless, micro-level data on sectoral attitudes over the exchange rate examined by Frieden himself (with Broz and Weymouth) (2007) reveals that most EE enterprises have not usually considered the exchange rate as an obstacle to their business activities.[285] The claim is also supported by evidence from my field interviews with policy-makers and representatives of industries in several EE countries. EE exporters remained competitive on the world markets in spite of currency appreciations and did not lobby for currency devaluations.[286]

Frieden (2002) introduces an additional caveat to the sectoral theory: the distributional impact of exchange rate changes are contingent on the impact of exchange rate "pass-through," that is, the extent to which an exchange rate change is reflected in the prices of imported goods.[287] Many EE states started the transition with a heavy reliance on the export of raw materials, in which subsidized energy and metal

[284] During the post-stabilization period from the mid-1990s, exchange rates of most EE currencies appreciated in real terms as a result of initial domestic price liberalization, exchange-rate-based stabilization programs, productivity changes in tradable sectors (Balassa-Samuelson), and increasing capital inflows.

[285] Broz, Frieden, and Weymouth (2007) use firm-level data from the World Bank's World Business Environment Survey administered to owners and managers of over ten thousand firms in eighty countries in 1999. They looked at individual responses to the following question: "How problematic is the exchange rate for the operation and growth of your business?" They report that the responses of enterprises in most EE countries are below average values.

[286] Author's interview with Ján Vlčko, Associate Director and Juraj Paľa, Director of the Department of the European Union, Slovak Chamber of Commerce and Industry, December 13, 2005, Bratislava. Also, Author's interview with Ján Oravec, President of the National Union of Employers (representing enterprises with foreign capital in Slovakia), December 15, 2005, Bratislava.

[287] Industry's sensitivity to exchange rate changes thus depends on the degree to which it exports products to foreign markets, uses foreign-made goods, or competes with foreign producers on the basis of price (Frieden, Ghezzi, and Stein 2001).

sectors enjoyed a privileged status. Alternatively, they specialized in labor intensive industries and produced standardized products (textiles, apparel, furniture, etc.). The industrial and export composition in some EE economies have changed over time. In many CIS republics like Russia, Moldova, Ukraine, Uzbekistan, and Kazakhstan, the energy and raw material sectors remained the leading export sectors (table 5.3). For example, in post-communist Russia, oil oligarchs replaced heavy industry, the military-industrial complex, and agricultural producers that had dominated the Soviet command economy (Rutland 2001). According to the sectoral argument, these producers of standardized commodities with a high degree of pass-through should be less concerned about currency fluctuations but should prefer a depreciated currency, and thus a flexible regime.

In CEB, industries previously dependent on the CMEA markets declined, e.g., energy production based on cheap Soviet energy supplies, agriculture, and food products. On the other hand, more capital intensive industries and exports of specialized and differentiated products gained importance, e.g., telecommunications, automobiles, and information technology (Eichengreen and Kohl 1998, Bohle and Greskovits 2004, King 2002) (table 5.3). For Frieden (2002), these producers, who care more about market share (quality, service, and customer loyalty) than about price should be sensitive to exchange rate volatility but relatively insensitive to exchange rate level: they should prefer a fixed regime. So, for a purely sectoral argument to hold, both Macedonia producing mainly standardized commodities (textiles and steel) or Armenia exporting primary products, and thus competing on the basis of price, should have pursued flexible regimes (table 5.3). Here again, the observed empirical variation on exchange rate regimes in EE ties to a weakness in the sectoral literature.

A misfit between structural characteristics of EE economies and their exchange rate strategies is also apparent. In the OCA framework, variation in exchange rate

regimes in CEB is considered to be a function of the size of the economy and the flexibility of labor markets, the reason that Poland's big economy exhibits a more flexible regime than Estonia's much smaller economy. This is also the reason why Hungary and Estonia with flexible labor markets have pursued a fixed regime, while the Czech Republic with a less flexible labor market abandoned a peg (Coricelli 2002: 408). But the contrary seems to be true: on average, larger EE countries were more likely to fix their currencies than the smaller ones (Von Hagen and Zhou 2002).

Table 5.3: Main Export Commodity Groups between 1993 and 1997

Country	*Main export commodity groups*
Albania	Clothing (28%), footwear (22%)
Armenia	Diamonds (74%), metalliferous ores (9%)
Azerbaijan	Cotton (29%), oil (21%)
Belarus	Clothing (21%), fertilizers (9%)
Bulgaria	Clothing (18%), non-ferrous metals (11%)
Croatia	Clothing (24%), footwear (9%)
Czech Republic	Vehicles (12%), electrical machinery (9%)
Estonia	Oil (23%), wood (14%)
Georgia	Oil (23%), iron & steel (18%)
Hungary	Electrical (12%), power machinery (12%)
Kazakhstan	Non-ferrous metals (39%), oil (29%)
Kyrgyz Republic	Gold (27%), cotton fibers (25%)
Latvia	Oil (41%), wood (23%)
Lithuania	Clothing (23%), oil (20%)
FYR Macedonia	Clothing (34%), iron & steel (20%)
Moldova	Clothing (25%), iron & steel (19%)
Poland	Clothing (11%), vehicles (8%)
Romania	Clothing (30%), iron & steel (10%)
Russia	Oil (32%), non-ferrous metals (20%)
Slovak Republic	Iron & steel (13%), vehicles (12%)
Slovenia	Vehicles (13%), electrical machinery (10%)
Tajikistan	Cotton (62%), textiles (17%)
Turkmenistan	Cotton (56%), textiles (18%)
Ukraine	Iron & steel (27%), metalliferous ores (15%)
Uzbekistan	Cotton (82%), non-ferrous metals (7%)

Source: Adapted from the EBRD Transition Report 1999: 179.

A problem with the explanations based on OCA theory is that they do not provide sufficient variation in determinants to account for changes of currency regimes over time, for structural characteristics of economies do not change often. OCA explanations are poor predictors of Russia's back-and-forth exchange rate policy between fixed and flexible regimes in spite of the relatively unchanging structural characteristics of its economy. OCA is also wrong about the ruble zone. The initial IMF recommendations to the post-Soviet republics, couched in terms of OCA theory, were to remain within the ruble zone. Since intra-USSR trade was disrupted and the tendency to use barter accelerated in 1992, preserving the common currency was promoted on the ground that it was a bulwark against these unfavorable economic developments (Pomfret 2003: 602).[288]

Nonetheless, from the perspective of individual republics, membership in the ruble zone was associated with two important problems. First, there was a shortage of cash because the initial Russian reform program was based on a restrictive monetary policy, which led the other ruble zone members to issue parallel currencies to alleviate the cash shortage. Second, the institutional setting of the ruble zone encouraged inflationary monetary policy: all ruble zone members retained control over domestic credit creation, but there was no institution that could have effectively exerted monetary control over the ruble (Pomfret 2003: 602–603, Abdelal 2001: 68). Many ex-Soviet republics exited the ruble zone right before Russia itself dissolved it. Thus, OCA does not explain the causes of ruble zone collapse, either.

This leads us to consider the importance of the IMF and other external actors in influencing exchange rate regime choices of EE governments. First, Estonia and other Baltic states show that it is possible to sustain fix even with liberalized capital

[288] See also IMF World Economic Outlook, Spring 1992, Washington, D.C.:41-2.

flows. Second, no doubt that the "IMF-World Bank complex," as Grabel (2003) puts it, tried to monitor monetary institutions and exchange rate policies in transition economies with the objective of "importing" credibility from abroad vis-à-vis market agents. But the IMF was rather reluctant to advise EE governments to adopt fixed regimes at the outset of the transition because it was unwilling to provide stabilization funds to those countries that lacked adequate foreign reserves to defend pegs, as the case of Estonia clearly illustrates (Sachs 1996).[289]

In addition, the IMF has not been consistent in recommending exchange rate policies on countries taking structural loans in the last thirty years. At the beginning of the 1990s, the conventional wisdom of the Fund was more favorable to fixed exchange rate regimes and their associated stabilizing and trade-promoting benefits.[290] This position changed after the financial crises in emerging markets in the 1990s when the IMF seemed to become more favorable to flexible regimes under conditions of capital mobility.[291] The current strategy of the IMF is to recommend a currency regime based on the country's economic fundamentals, to stress convertibility and transparency in currency arrangements, and to discourage competitive devaluations.[292]

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[289] In fact, many of the drastic adjustment programs in EE states proposed by the IMF have typically been self-imposed, to which the IMF has given "its blessing rather than having been the primary initiator" (Bruno 1992: 74).

[290] Countries were also expected to reduce government spending by precluding printing of fiat money and granting aid to state owned enterprises in financial difficulties.

[291] These financial crises took place with pegged rates, which deprived the countries concerned of flexibility to make appropriate adjustments.

[292] Author's personal conversation with Rodrigo Rato, former Managing Director of the IMF, Berkeley, CA, February 2, 2006; author's interview with Willy Kiekens, IMF Executive Director, June 6, 2006, Prague. Also, IMF Art. IV. 1. iii. states: "Member countries can choose any exchange arrangement that suits them, under the condition that it is consistent with the general objective of the IMF, which is to foster 'orderly economic growth with reasonable price stability.' Countries should avoid manipulating exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

Not only is the IMF inconsistent in its policy recommendations but post-communist countries, even the ones that are not "the Golliaths of geopolitics" as Ganev (2005: 368) puts it, often did not follow its recommendations. While the IMF has supported the establishment of the currency board in Lithuania, its stance differed from that promoted in Estonia. The decision to adopt a currency board in Estonia was a national choice in spite of the disagreement with the IMF (Nenovsky, Hristov, and Mihaylov 2002: 7). Similarly, the nationalist Mečiar government in Slovakia refused to agree to a 30 percent currency devaluation suggested by the IMF in February 1993.[293]

A different approach to examining the role of international factors focuses on broader foreign policy choices and strategic state concerns. In accordance with the premises of national purpose analysis put forward by Abdelal (2001), the paradoxical adoption of a currency board by Estonia after it exited the ruble zone, with the Deutsche mark as the anchor currency, involving the loss of the newly established monetary authority out of Russia to the Bundesbank, was partly motivated by the objective to politically link national autonomy from Russia to a new statehood in Europe.[294] In this theoretical perspective, we would expect the EE countries that have tried to pursue economic reintegration away from the ex-Soviet Union towards Europe to fix their currencies to the deutsche mark (the euro). The support of the West can hardly have led to the Estonian policy of radical monetary autonomy from Russia because at that time, the European Community urged the Estonian government to be cautious in introducing its own currency (Laar 2002: 117). More important, the nationalist perspective has a difficult task explaining why a political consensus

[293] Author's interview with Peter Ševčovic, Member of the Bank Board and the Executive Director for the Monetary Area and Statistics of the NBS, December 14, 2005, Bratislava.

[294] Also, personal discussions with Rawi Abdelal.

concerning the exchange rate policy was initially lacking in Latvia and Lithuania, two countries that had also departed from the ruble zone early on with a similar objective of pursuing a policy of radical economic autonomy from Russia. As illustrated earlier in this chapter, these two Baltic states opted for a more gradual approach to monetary reform and they experienced a short transition period with a discretionary central bank, monetary policy accommodating interest groups, and flexible exchange rate regimes.[295] Moreover, the three Baltic states differed in terms of the anchor currency, to which they chose to peg. These Baltic countries chose to peg their new currencies to non-European currencies: Latvia to SDR and Lithuania to the U.S. dollar.

More generally, in the context of the fifteen post-Soviet successor states Cooper (2007) finds that the national purpose perspective itself cannot explain the sequence of the departure from the ruble zone: Ukraine and Kyrgyzstan, neither of which had a coherent, unified national identity, left the ruble zone early, while states with well-established national identities like Georgia and Moldova were slow to exit the ruble zone. It is also hard to argue that all EE states with EU integrationist ambitions chose to peg their currencies to the European anchor. While in some states, exchange rate stabilization against the euro has recently gained a more prominent weight, this may simply reflect the increased trade and financial orientation to the EU. Out of this group, only a few countries have consistently pursued fixed regimes from the date that they signed the Europe Agreements.[296] It should be also noted that while the EU accession process implies legally binding trade and financial liberalization, the European Commission leaves accession countries free to adopt any exchange rate

[295] While Latvia and Lithuania began with flexible exchange rate regimes, during this period they exhibited nearly stable exchange rates brought about central bank interventions (Hansson 1997: 267, fn. 17).

[296] Slovenia and Slovakia entered the EMU in January 2007 and January 2009. Estonia and Lithuania joined the Exchange Rate Mechanism II in 2004.

regime including a currency board.[297] However, it rules out unilateral euroization, that is, replacement of domestic currency by the euro, until full acceptance into the EMU.[298] Still, the adoption of the *acquis communautaire* by EE countries includes coordinating macroeconomic policies that require low inflation and fixed regime is considered to be a direct commitment to economic stabilization and closer cooperation with the EU.

In sum, while the national purpose analysis may explain the exit from the ruble zone in some EE states, it is inadequate in explaining the subsequent decisions about exchange rate policies as well as financial reforms. The indeterminacy of the national account with regards to financial development policies can again be demonstrated by comparing the experiences of the three Baltic states. Although almost 60 percent of the Latvian banking system is owned by banks from Sweden and other Nordic countries, foreign bank ownership in Latvia is much lower than in Estonia and Lithuania. Domestic banks and a few small banks owned by investors from CIS countries continue to play an important role in Latvia. These banks rely on more fragile forms of foreign financing, mainly short-term syndicated loans and non-resident deposits, which face notable redemption pressure in the context of the global financial crisis of 2008. Most of these foreign assets were concentrated within the

[297] In the field of trade policy, there is no room for derogation in the EU's single market. In competition policy, the EU declares any public aid, which distorts competition by favoring certain undertakings or the production of certain goods, incompatible with its competition policy. The EU has also influenced the development of banking sectors in EE states by pressuring for liberalization and privatization and for dismantling protective barriers to entry (Lindstrom 2005).

[298] The European Commission's view is that "any unilateral adoption of the single currency by means of 'euroization' would run counter the underlying economic reasoning of EMU in the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence process within a multilateral framework. Therefore, unilateral 'euroization' would be a way to circumvent the stages foreseen by the Treaty for the adoption of the euro" (EC-DG-II, 2001: 21). Some commentators argue that the real reason behind this aversion of EU politicians to unilateral euroization is the fear that the exchange rate, at which a country unilaterally euroizes, might be excessively undervalued and undermine the competitiveness of EU exports. The European Central Bank may also fear that it would be obliged to provide lender of last resort liquidity to a unilaterally euroizing country (Jackowski and Rostowski 2002, Nuti 2002).

Parex Bank, the second largest bank and the largest domestically owned bank and a few smaller domestic banks. The international financial crisis has brought the vulnerabilities of the Latvian economy to a head, which culminated in a run on Parex Bank in August 2008, coalescing into a financial crisis. The Latvian government turned to the IMF, which approved an emergency loan program centered on maintaining the country's exchange rate (IMF 2009). While the other two Baltic states share key macroeconomic imbalances, they have not experienced a full-blown financial crisis because their financial systems are more open with greater participation of Western banks. Latvian banks for a long period had very strong ties to the Russian and CIS markets and exploited the interest rate differential between those markets and the Latvian one. Large portions of savings and foreign currency accounts in Latvian banks are still owned by depositors from Russia and other CIS republics. This reflects stronger economic links with Russia, notably through the large Russian-speaking minority in Latvia, which has maintained its contacts with the Russian commodities business (Adahl 2002).

Finally, policy recommendations with regard to optimal exchange rates for EE countries were also ambiguous. Some commentators like Sachs (1996) recommended that EE countries adopt more flexible arrangements once high inflation was eliminated, while others like Coricelli (2002) warned that floats associated with high interest rate spreads and the vulnerability of domestic economies to external shocks can have negative effects.

The central lesson of this chapter is that although external pressure, credibility, structural characteristics, and preferences of the industrial sectors are important, by themselves they are of little use in explaining the variety of exchange rate regime choices in the EE region. The differences in the evolution of exchange rate regimes in EE reflect both the depth of ownership and institutional reforms in the financial sector,

as well as successful macroeconomic stabilization. They reflect variation in the determination of EE governments to cut ties with financial and industrial incumbents and to pursue disinflation, to establish independent central banks and effective regulatory institutions, to implement budget discipline and pursue financial and trade openness. In societies where governments were reluctant to devise a strategy for breaking the power structure and to liberate banks from non-banking constraints by privatizing them, uncertainty and inflation remained high. High inflation favored short-term considerations. Uncertainty over property rights undermined the confidence of foreign investors. Therefore, as Wyplosz (1999: 17) argued, "There was thus a virtuous circle involving stabilization, limited exchange rate flexibility and low inflation, and a vicious circle where runaway inflation and exchange rate flexibility were the consequence of the absence of macroeconomic stabilization."

In an effort to gain a fuller empirical picture of the connection between financial interests and institutions on one hand, and exchange rate choice, on the other, the following chapters present detailed tracing of the processes of exchange rate policy making in four specific post-communist states.

CHAPTER 6

ESTONIA AND BULGARIA: COMPETITION AND CAPTURE

The confidence of the Estonian kroon depends on the actual power of Bank of Estonia over the commercial banks.

Siim Kallas and Mart Sõrg[299]

… the prevailing part of the banks was included in various "bandit" coalitions with people from the government, parties, and the business. Their sole goal was quick and single enrichment on the account of the public. Notions like "connected lending, inside lending, informal lending… were common phenomena in Bulgaria at that time.

Bertlemann, Hristov, and Nenovsky[300]

In this chapter and subsequent chapters, I will further develop my finance-based theory by presenting four detailed cases to illustrate the role of finance in exchange rate policy. These cases represent four different types of financial systems that offer empirical leverage on the question of exchange rate regime choice and sustainability. In all four cases, ownership structure and the institutional nature of the financial systems were crucial influences on the direction of exchange rate policy-making. For each of the four country studies, financial development and exchange rate policies are evaluated as part of the historical narrative. It should be noted that the case chapters illustrate only the functioning of the causal mechanism in my finance-based theory, rather than offering an encompassing analysis of fifteen years of political and economic transition.

Chapter 4 provided statistical evidence concerning the determinants of choice and sustainability of exchange rate regime. These quantitative results showed that the financial systems dominated by foreign and private banks, accompanied by strong

[299] Kallas and Sõrg (1994: 14).

[300] Bertlemann, Hristov, and Nenovsky (2002: 23).

monetary and regulatory institutions, were associated with a higher probability of fixed exchange rate regimes in any given year than those dominated by incumbent government banks. So, decreasing participation of SOBs and increasing presence of foreign banks in the financial system increases the likelihood that a country would pursue a fixed exchange rate regime. A combination of quantitative indicators and qualitative evaluation is used in the country studies to trace the process of exchange rate policy making by focusing on the principal elements that establish the argument: first, how a financial system is developed through liberalization of bank entry and various methods of divestiture of state assets in banks and enterprises; and second, how a financial system is structured by examining the different aspects of the primary explanatory variable used in econometric models presented in chapter 4 that reflect several dimensions of post-communist banking sector reform including the separation of commercial banking activities from the central bank, the use of directed credit, the quality of prudential regulation and supervision, and the central bank authority.

Before I proceed with examining evidence from four case studies, I would like to advance the following argument. Initial exchange rate choices in EE were part of stabilization and economic reform packages, together with financial sector reform and privatization. Although financial reforms (two-tier banking structure, liberalization of entry, privatization) belong to the structural reform phase, they had to be launched immediately or at least made public to add credibility to the stabilization packages, for creating a market environment primarily meant having a well-functioning financial system.[301] The standard instruments of monetary and fiscal stabilization required a two-tier banking system, which would allow the central bank to influence monetary creation by the commercial banks through an interest rate policy (Lavigne 1999: 115–

[301] Some argue that what communism left behind was, in institutional terms, a *tabula rasa* (Elster, Offe, and Preuss 1998). It should be noted, however, that informal institutions always persist under the veneer of formal institutional change. I am grateful to Peter Katzenstein for this thoughtful remark.

117). Privatization of banks and enterprises required establishing legal grounds and institutions, finding buyers for state-owned assets, and monitoring how the privatization process progressed. Therefore, actually implementing privatization was slower than adopting initial exchange rate regimes. Seen in this light, this study underlines a government commitment to a fixed regime accompanied by a commitment to liberate economic policies from the influence of incumbent banks and enterprises through financial openness and privatization to outsiders at the outset of the transition. This leads to a gradual decrease in participation of incumbent banks and an increase in participation of foreign banks in financial intermediation. If a country allowed foreigners to assume the role of strategic investors in SOBs through privatization, it was able to build an open financial system, which was in turn was associated with sustainable exchange rates.[302]

This chapter looks at two contrasting cases of exchange rate policy making in Estonia and Bulgaria. These two countries are different from each other in their approach to financial institutional reform but similar in terms of the general problems of communism that EE experienced as a whole. Estonia exhibited a cumulative trajectory of its post-communist transformation experiment. The government adopted a currency board (CB) arrangement in April 1992 in the wake of independence. A hard peg was a major part of the initial macroeconomic stabilization program that was accompanied by the liberalization of the newly established financial system. From the outset of the transition, there was a strong political will to commit to a rigid fixed regime that simultaneously required the political will of government to discipline its monetary and fiscal policies, and thus to resist demands from incumbent interest groups for credit. This goal was achieved by the radical withdrawal of the state from

[302] As argued in chapter 3, the key element of financial development in EE has been the divestiture of state assets in the banking sector through privatization to foreign strategic investors, rather than simple openness to foreign (greenfield) banks.

banking through privatization, hard budget constraints imposed on incumbent banks and enterprises, and the government's commitment to open the domestic banking sector to foreigners. A "competitive" financial system characterized by an institutional environment free from the political involvement of incumbent financial and industrial interests in resource extraction was in turn a crucial precondition for the continuity of a CB. It is remarkable that the Estonian government was able to sustain a hard peg throughout the entire transition even with changing presidents and parliaments, several bank failures, and the 1998 Russian financial crisis.

Bulgaria started its economic transition experiment with slow reforms and inconsistent economic policies. Its exchange rate policy can be divided into two periods, which are also associated with different approaches to macroeconomic stabilization and financial reforms. During the 1990–1996 period, Bulgarian governments on both left and right proved unable to cut their ties with financial and industrial incumbents and to commit to a credible stabilization program based on a fixed exchange regime. Instead, a flexible regime adopted in 1991 allowed stabilization and financial reforms to be delayed, and a financial system of "capture" to be created. The influence of powerful incumbent interests capturing the government and the central bank, led to repeated bailouts of financially troubled government banks and enterprises, monetization of the budget deficit, and repeated devaluations of the national currency. Only when the 1996–1997 dramatic twin crisis—banking and currency crisis led to the collapse of one third of banks, hyperinflation, and a run on the currency, Bulgaria adopted a highly restrictive CB insulating the central bank from political manipulation. Because the financial crisis was primarily due to systematic moral hazard behavior of the banks, mostly SOBs, widespread political support was generated to implement delayed painful yet necessary stabilization and privatization reforms.

Bulgaria and Estonia share institutional legacies from the socialist era as well as a number of features important for making decisions on exchange rate regimes. First, both countries are small and open economies that have been highly dependent on international markets.[303] These are the countries that have faced several external constraints and have been influenced by international actors, the IMF in particular, restraining their policy autonomy more than for large countries.

Second, in contrast to Poland, both Bulgaria and Estonia were fully developed communist states along the standard Soviet lines, with full nationalization of production and services, collectivization of agriculture, and five-year plans. Both countries became dependent on trade with the Soviet Union and CMEA. The Soviet system was centralized and its planning structures highly integrated, which had resulted in high economic dependence of the post-Soviet republics. In the second half of the 1980s, only 2–3 percent of Estonia's exports went outside the Soviet Union and two thirds of these exports were to other CMEA countries (Kukk 1997: 262). The collapse of the Soviet empire thus caused a deep trade shock and economic recession in Estonia. Similarly, Bulgaria was perceived as the EE country closest to the Soviet Union, at least since the 1960s. Bulgaria's industrial structure was the result of late, socialist industrialization, oriented towards the Soviet markets.[304] While a number of CMEA member countries attempted to reorient their trade flows to/from other trading partners in the 1970s and 1980s, the degree of Bulgaria's dependence on trade with the Soviet Union reached over 50 percent of overall Bulgarian trade. Thus, the shock to the Bulgarian economy resulting from the disintegration of the CMEA bloc resembled a trade shock, which led to shortages of goods and raw materials and a loss of

[303] The CIA fact-book reports that in 1995, Bulgaria's GDP at PPP was 46 billion U.S. dollars and Estonia's GDP at PPP was 12 billion U.S. dollars.

[304] Author's interview with Veselin Mintchev, Bulgarian Academy of Sciences, Institute of Economics, June 27, 2007, Sofia.

Estonian export markets during the disintegration of the Soviet Union (Dobrinsky 2000: 582–3).

In both countries, the collapse of the Soviet system caused a collapse of output that coincided with hyperinflation following price liberalization which resulted in a deep recession.[305] Their reform programs also started with a relatively similar property rights structure and degree of state ownership.[306] In addition, these two countries shared two other legacies that are important in exchange rate policy-making. One was a very low level of international reserves in the initial years of transition, where their only access to foreign financing was at the door of international financial institutions. The level of foreign reserves influences a country's ability to commit to a fixed regime. The other similarity was the widespread dollarization of their economies. When the degree of dollarization in an economy is high, a fixed regime is usually preferable to stabilize the economy, for sudden changes in transaction uses of domestic and foreign currency may produce large swings in the exchange rate.[307] Finally, both Estonia and Bulgaria joined the EU in May 2004 and January 2007 and should have had powerful external incentives to align with the policies of fixed regimes in the single currency area. Given these similarities, any observed variation in economic policies and institutions for these two countries is noteworthy.

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[305] The cumulative fall in real GDP was about 35 percent in Estonia for the years 1991–1994 (over 25 percent during 1991–1992), and 28 percent in Bulgaria for the years 1989–1993 (Minassian 1998: 331, Knobl, Suitt, and Zavoico 2002: 9). In fact, many predicted that Estonia faced a gloomy post-authoritarian future in the shadow of its powerful neighbor, Russia. Not only was Estonia closely connected to the Soviet economy but it had only a brief period of independent statehood from 1918 to 1940, and its democratic experience had been short-lived (Bennich-Bjorkman 2007: 317).

[306] In Bulgaria, there were some early attempts at economic reforms during the period 1982–1986, when the Bulgarian party-state bureaucrats tried to increase efficiency by enhancing the self-management of enterprises. The main ideological credo was "the state as owner and the workforce as steward." In 1989, the government adopted Decree 56 on Business Activity, preserving the self-management approach but transferring control rights from workers to managers (Peev 1995).

[307] The ratio of foreign currency deposits to broad money (a commonly used measure of dollarization) was over 20 percent at the time a CB was introduced in Estonia. In Bulgaria, this ratio amounted to 30 percent in 1991 (Balino, Bennet, and Borensztein 1999).

The structure of this chapter is as follows. Before I enter into a detailed analysis of the events surrounding exchange rate policy making, a word is in order on the broader economic context in which it was carried out. Exchange rate policy is part of overall macro-economic policies, so I will begin discussing the country's overall transformation strategy. Later sections trace the principal elements of the finance-based theory by focusing on how the financial system was developed; the position of the central bank, the strategies of banks and industrial enterprises in exchange rate, monetary, and regulatory policies; and how government policies were affected in regard to their exchange rates.

Estonia

The Monetary Reform and Currency Board

Estonia was among the first Soviet republics to break away from the former Soviet Union[308] and the first country of the ex-Soviet Union to establish its own currency.[309] Monetary reform was the most important component of postcommunist reforms. The first real step toward monetary reform was undertaken in January 1990 when the Estonian Supreme Council declared the Bank of Estonia (*Eesti Pank*, BOE),

[308] Estonia had a brief independence during the interwar period. Following the Molotov-Ribentrop Pact, it was invaded by Soviet troops in 1939, then occupied by the Nazis in 1941, and finally annexed by the Soviet Union in 1944. The country declared its independence on August 20, 1991. See Taagepera (1993).

[309] The idea of Estonia's own currency was already emerging in August 1987, when four Estonian social scientists in the Tartu daily Edasi forwarded a proposal for economic autonomy in Estonia (known as the "Four-Man Proposal"). Among the authors of the proposal were Edgar Savisaar, the first Prime Minister of independent Estonia and Siim Kallas. During the late communist period, they had already proposed the so-called Isemajandav Eesti, a program of economic self-management to move Estonia away from the Soviet Union. Interestingly, the plan was known by its initials, IME, the Estonian word for miracle (Kallas and Sorg 1994: 3, Knobl, Sutt, and Zavoico 2002: 4). In fact, it is claimed that the Estonian opposition movement, the Popular Front, formed in 1988, was largely a movement to fulfill the IME project (Terk 2000: 23). In 1990, the Supreme Council of the Republic of Estonia adopted the resolution "on the current situation in banking and the realization of the program of the transition to the Estonian currency," which assigned the government and the central bank the task of preparing for monetary reform. The principal administrator was Rein Otsason, President of the BOE.

the legal successor of the central bank that existed before 1940, with the task of preparing the introduction of a national currency.[310] The commitment to currency reform found expression in the formation of the Monetary Reform Committee in March 1991 by the Supreme Council, whose members were committed to market-based reform.[311] The combination of independence granted on 20 August 1991 and the appointment of Siim Kallas as governor of the BOE in September 1991 gave an important impetus to the momentum for the reform (table 6.1). The BOE, which was the intellectual locomotive of market reforms, gained a governor that had been at the forefront of the currency reform debate for several years (Knobl, Sutt, and Zavoico 2002: 6). It is interesting to note that the Ministry of Finance was not a significant policy player in monetary reform at that time (Buyske 1997: 77). However, the Savisaar government (1990–1992) began to lobby the BOE for currency reform based on the introduction of vouchers (temporary supplements to the ruble) on the grounds that it would leave more time to make important decisions on the exchange rate regime (table 6.2).[312]

The deterioration of economic conditions underlined the urgency of fast and coherent reforms. The post-Soviet economic shocks were strong, particularly the rise of prices approaching hyperinflation: while in 1991, the annual inflation was above

[310] The BOE was originally founded in February 1919 when Estonia first gained its independence, but it was closed in June 1941 following the country's annexation by the Soviet Union. For a detailed history of the BOE, see www.ee/epbe/en/history.hmtl.

[311] The Monetary Reform Committee consisted of 3 members: the Prime Minister, the governor of the BOE, and an independent expert. The founding members were Edgar Savisaar, Rein Otsason, and Siim Kallas. In February 1992, the new committee included Tiit Vähi (Prime Minister), Siim Kallas (Governor of the BOE), and Rudolf Jakalas, the Estonian-born Swedish banker (Laar 2002: 113).

[312] There were alternative proposals for monetary reform. For example, Estonian Professor Vello Volt suggested introducing payment vouchers or a convertible ruble (koru) to restrain the spread of inflationary effects of the ruble zone into Estonia. Another proposal was to declare the Finnish currency as the official legal tender together with the Estonian currency. This proposal was inspired by the experience of 1918, when the Finnish currency was in circulation in Estonia (Laar 2002: 109).

200 percent, by 1992, it reached close to 1,100 percent (Staehr 2004: 45).[313] The BOE and the Estonian Savings Bank issued checkbooks to alleviate the shortage of cash but these were not very popular among the population.[314] The confidence in the inflationary ruble (the "occupation ruble") was lost. The Savisaar government, blamed for the bad economic situation and delays in economic reforms, fell in January 1992 and was replaced by a caretaker government led by Tiit Vähi, the former transport minister.

Table 6.1: Governors of the Bank of Estonia, 1990–2007

Governor	*Tenure*	*Background*
Rein Otsason	December 28, 1989–September 23, 1991	Economist (Head of the State Plan Committee)
Siim Kallas	September 23, 1991–April 27, 1995	Politician (Member of the Supreme Council of the USSR)
Vahur Kraft	April 27, 1995–June 7, 2005	Banker
Andres Lipstok	June 7, 2005	Politician (Minister of Finance, Minister of Economic Affairs, member of Riigikogu)

Source: Bank of Estonia, various sources.

[313] The main factors that contributed to inflation included not only Russia's mismanagement of the ruble, but also price liberalization, the elimination of Soviet subsidies on imported raw materials, and the deliberate undervaluation of the new currency (Brown 1993: 494-495).

[314] To alleviate cash shortages, the Tartu City Government introduced its own currency, which was quickly abolished by the BOE (Laar 2002: 119).

Table 6.2: Governments in Estonia, 1990–2003

Duration of Government	Prime Minister	Party affiliation of Prime Minister
1990	Edgar Savisaar	Popular Front
1992	Tiit Vähi I	Estonian Coalition Party
October 21, 1992–November 2, 1994	Mart Laar I	Pro Patria Union
November 3, 1994–April 16, 1995	Andres Tarand	Independent
April 17, 1995–March 13,1997	Tiit Vähi II	Estonian Coalition Party
March 14, 1997–March 28, 1999	Mart Siimann	Estonian Coalition Party
March 29, 1999–January 27,2002	Mart Laar II	Pro Patria Union
January 28, 2002–April 9, 2003	Siim Kallas	Estonian Reform Party

The IMF (and the European Community) disapproved of introducing an independent Estonian currency on the grounds that the Estonian government would not be able to stabilize its currency because of the lack of foreign exchange reserves.[315] In April 1992, the IMF negotiating mission submitted to the Estonian authorities a Memorandum of Financial and Economic Policies, suggesting a freely floating exchange rate. However, Kallas, the BOE governor, was committed to urgent currency reform and expressed great interest in a CB arrangement. He was attracted to this currency regime because the regime was associated with a degree of transparency and credibility similar to that of the gold standard, under which Estonia experienced

[315] The IMF was apparently concerned that monetary reform in Estonia could create problems for monetary reconstruction in Russia, which was the institution's predominant focus. Author's interview with Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999–2002), July 19, 2007, Tallinn. See also, Hansson and Sachs (1992: 1–2). Stanley Fisher (1997: 17) described the doubts of the international financial community about the initial regime choice of Estonian authorities at a conference on the 5th anniversary of the Estonian kroon in 1997: "Many of those who heard about the intention to introduce the CB in 1992 were doubtful that it could succeed."

monetary stability during the 1927–1933 period.[316] Kallas worried that if a flexible regime was chosen, the constant disputes and political pressures would cause extra confusion and dual money circulation in the unstable post-communist landscape (Kallas 2002: 130).[317] Instead, a CB promised an immediate solution to the problem of resisting demands for credit from the government and incumbent interest groups.

It is unclear who was the first to seriously suggest the idea of a CB in Estonia. According to Prime Minister Laar, the initial idea about adopting a CB in Estonia came from Jeffrey Sachs,[318] who arrived in Tallin in April 1992 accompanied by Ardo Hansson and Boris Pleskovic.[319] Simultaneously, Swedish and American academics Lars Jonung, Steve Hanke, and Kurt Schuler also proposed a CB arrangement. According to their proposal, Sweden would grant Estonia the initial reserves to establish a new CB in the amount of six hundred million Swedish krona. The CB would have three Swedish and two Estonian representatives, who would enjoy the exclusive right to emit the Estonian currency fully backed with gold and foreign currency reserves (Hanke, Jonung, and Schuler 1992). This proposal, however, did not find full support of the Estonian authorities, for the BOE had been removed from

[316] A CB is a fixed exchange rate regime similar to a gold standard regime. The authorities forego discretionary control over the money supply and replace it with an automatic mechanism that links money supply changes to the balance of payments. The amount of foreign exchange reserves that the CB stands ready to exchange for domestic money is sufficient to cover the monetary base.

[317] The Estonian authorities feared that with a flexible regime, the kroon (along with ruble, for to stop its use would have been a contentious issue) and convertible foreign currencies would have remained in circulation (Ennuste et al. 2004: 21).

[318] Author's interview with Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999–2002), July 19, 2007, Tallinn.

[319] Ardo Hansson was an Estonian-born economist from the World Bank, who has also worked as a member of Anders Aslund's reform adviser team in Slovenia and elsewhere in EE. He was also advisor to Prime Ministers Vähi and Laar. Hansson brought Estonian policy-makers into contact with Western economists associated with Sachs and Aslund (Feldmann and Sally 2002: 90). Boris Pleskovic was economic advisor to the Prime Minister of Slovenia and had had experience with the Slovenian currency reform.

regulating the circulation of money. There were also problems getting a loan from Sweden; moreover, the suggested amount of reserves for the Estonian CB to operate with was considered insufficient (Kallas and Sorg 1994: 5).[320]

In spite of IMF disapproval and discontented incumbent interest groups, Prime Minister Vähi successfully introduced the long-awaited Estonian currency and a CB arrangement in June 1992.[321] At that time, the Estonian Parliament (*Riigikogu*) passed three laws regarding monetary and exchange rate policy: the currency law, the law on the backing of the Estonian kroon, and the foreign exchange law defining the CB and its operating procedures.[322] The Decree on the Monetary Reform Committee from 17 June 1992 "on the performance of the currency reform" provided the main features of the currency reform and established the Estonian kroon as the sole legal tender starting on June 20, 1992 (Kallas and Sorg 1994: 10–11).

The main goals for exchange rate policy were stability and credibility (Pautola and Backé 1998: 78). Although Estonia did not comply with OCA criteria at the time of CB adoption, the Deutsche mark, endowed with a reputation for credibility from the Bundesbank's commitment to low inflation, was considered an appropriate anchor (Sulling 2002: 472).[323] The exchange rate between the kroon and the Deutsche mark

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[320] Yet another proposal was submitted by Holger Schmieding, who suggested a CB for all three Baltic states. He suggested pegging a common Baltic currency to the ECU and *Banque de France* as the manager of this common currency (Laar 2002: 110-111).

[321] The IMF eventually changed its approach and issued a statement of support the day before the currency was introduced (Brown 1993: 496). The Joint Statement by the Government of Estonia and the IMF on Currency Reform was published on June 19, 1992 in the IMF News Brief No. 92/16: 23.

[322] The Law on the Security of the Estonian Kroon establishes the CB principle. In order to provide transparency for the operation of the CB, the BOE is divided into Issue Department, which is de facto CB, which concentrates all high liquid assets and liabilities, and the Banking Department, which incorporates less liquid assets and the excess of foreign exchange reserves over the cover for monetary liabilities.

[323] In 1991, Germany accounted for only 0.2 percent of Estonia's total trade. Finland and Sweden, its current major trading partners, accounted for 2.3 percent and 0.5 percent (Sulling 2002: 472, fn. 4).

was set at 8 kroon to 1 Deutsche mark.[324] The official conversion rate for the pre-independence currency was 10 rubles to 1 Estonian kroon. Some government advisers pressed for a strong currency revaluation on the grounds that only this would generate the dollar income needed to purchase goods at "world prices" (Laar 2002: 122). For a successful CB arrangement, Estonia needed 120 million U.S. dollars of foreign reserves (Laar 2002: 120). At the time of the currency reform, only the gold restituted from the United Kingdom was available (52 million U.S. dollars). To support the newly established currency regime, the Estonian Supreme Council also decided to commit to the balance of the BOE reserve some areas from the state forest (which could have been sold in the event of crisis) with the estimated value of 150 million U.S. dollars as an additional guarantee of the foreign currency reserves (Kallas and Sorg 1994). The CB thus started with partial backing of the BOE liabilities but full backing was achieved only within a month after the monetary reform following further gold restitution.[325]

Before the monetary reform, incumbent banks (mostly government owned) carried out risky loan policies and speculations on exchange rates because rising inflation reduced the risk of crediting and increased profits from loans. Banks were using this unstable economic environment to make a lot of money. The BOE, not backed by strong legal independence initially, was weak in enforcing prudential

[324] The Swedish kronor, Finnish markka and ECU were also considered as candidates for the peg or even as candidates for full dollarization. The U.S. dollar was never suggested as a serious alternative during the discussions on the anchor currency. The argument against ECU was that a single currency peg was more transparent and simpler than pegs to currency baskets (Sepp, Lättemäe, Randveer 2002: 334-335).

[325] Before the occupation in 1940, Estonia had over 11 tons of gold abroad: 4.8 tons in the United Kingdom, 2.9 tons in Sweden and 3.3 tons in Switzerland in the Bank for International Settlements. Negotiations with these three countries were concluded successfully, and in mid-June 1992, the gold reserves of the BOE were restored (Kallas and Sorg 1994: 8-9). Forty-five million dollars was restituted from Sweden and the BIS in July 1992 (Knobl, Sutt, and Zavoico 2002: 14, fn. 30).

regulations and sanctions.[326] Being aware of this institutional weakness, banks expected the central bank to provide liquidity assistance and bail outs, which led to reckless lending and financial speculation, resulting in mismatches on their balance sheets (Hansson 1995: 150). Banks were unhappy with the adoption of a CB that required commitment from the government and the central bank to low inflation, a stable exchange rate, and financial reforms that would reduce bank profits. Former Prime Minister Laar recalls bank reactions at the moment that a CB was adopted in the Parliament:

> Banks were furious. They missed the moment because they did not know what the currency board meant. We did not say much about it in the Parliament before its adoption. There was only one economist from the Agricultural Party who understood what [the currency board] is and its consequences, and he voted against it.[327]

The Estonian Parliament gave substantial authority to the Monetary Reform Committee to conduct monetary reform and to decide on financial system reforms.[328] The effectiveness of this institutional mandate was reinforced by the highly technical nature of the Committee's work that limited the number of potential interest groups with sufficient expertise to follow or challenge its decisions (Buyske 1997: 82). It was not only banks but also many politicians who voted for the CB, which was adopted

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[326] Rein Otsason, then President of the BOE, pursued the idea of subordinating all SOBs directly to the BOE and transforming the central bank into an institution similar to the former USSR State Bank. However, this proposal was not put in place because of the opposition of some members of the BOE Board and the government (Sorg 1994: 6).

[327] Author's interview with Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999–2002), July 19, 2007, Tallinn. See also Lloyd (1994).

[328] Bo Kragh (quoted in Buyske 1997: 82), a proponent of the Monetary Reform Committee, described its extensive powers in the following way: "…it can determine the time of monetary reform, what to do with the Estonian financial system, taxes, debt, securities, pensions, wages, fines, foreign trade and with the USSR armed forces [in Estonia]." See also Transcript of the 33rd session of the Estonian parliament, 4th seating, March 14, 1991.

almost unanimously, for its implications were not fully grasped. Banks and politicians were convinced that even after monetary reform, the central bank or government would continue to provide "cheap credits" to failing factories and collective farms (Laar 2002: 121–122).

The Estonian CB is a semi-orthodox version of this arrangement (Khoury and Wihlborg 2006).[329] The BOE was prohibited by law from devaluing the Kroon; only the Parliament has this right. The choice of the CB was clearly a political choice because it helped Estonia to exit from the ruble zone, making the BOE independent from all government agencies and prohibiting it from financing any government debt, engaging in selling securities, and lending to banks or state-owned enterprises. Therefore, the CB arrangement meant that the BOE should focus on preserving a stable exchange rate, instead of trying to reach compromise among exchange rate stability, unemployment, and output growth (Kallas and Sorg 2002: 13). Kallas, the BOE governor, was a key member of the Monetary Reform Committee that established the CB. The decision to make the BOE responsible for the CB enhanced its authority; increased its capacity in relationship with the banks because the BOE is unable to serve as lender of last resort; and facilitated its task in maintaining a stable currency regime because the kroon is fully secured (100 percent) by gold and convertible foreign currencies and the conversion rate is established by law (Buyske 1997: 92). The currency regime proved successful in combating inflation, which was brought down to 89.8 percent in 1993 and to 29 percent in 1995 (Laar 2007: 5).

[329] As of 2006, the IMF classified only six other countries exhibiting a CB: Bosnia-Hercegovina, Bulgaria, Brunei-Darrussalam, Djibouti, Hong Kong SAR, and Lithuania. The unsuccessful Argentinean CB was the primary inspiration for Ardo Hansson (Laar 2002: 153-154). The Estonian and collapsed Argentinean CBs deviate from the orthodoxy of a central bank. Nonetheless, in contrast to Argentina where the central bank continued to finance the government, the BOE is not permitted to finance a government deficit. Author's interview with Ulo Kaasik, Head of the Economics Department of the BOE, July 18, 2008, Tallinn. For a review of the necessary conditions for the orthodox CB and the ways they were circumvented in all countries with CBs, except for Bosnia and Hercegovina, see Hanke (2002).

"Just Do It" Reform Strategy and Outsider Privatization

The CB has been a cornerstone of the economic reform program that included the continuation in price liberalization, a conservative fiscal policy, ultra-liberal trade policies, attracting foreign capital, and full scale privatization to facilitate market-based price and wage adjustments to changing internal and external conditions, rather than using the exchange rate (Kallas and Sorg 1994: 12, Sulling 2002).[330] Estonia's economic reform was predicated on a radical withdrawal of the state from the economy and finance and a shock therapy strategy of economic stabilization. Thus, many reforms were carried out simultaneously and adjustments were made to coordinate and link them together (Ennuste et al. 2004: 7).[331] The CB was established with fully liberalized current account transactions and a system of few capital controls, mostly abolished by the end of 1994. The government also introduced a flat tax of 26 percent (on personal and corporate incomes) and a legal requirement to eliminate state subsidies (including subsidies to agriculture) to maintain balanced budgets that have limited government ability to engage in ambitious redistribution policies.[332]

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[330] Laar maintained that openness of the economy, although politically unpopular, attracts foreign investments and fosters competition, reconstruction, and growth. Author's interview with Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999–2002), July 19, 2007, Tallinn. The Estonian government abolished all tariff and non-tariff barriers to trade. The average tariff rate in Estonia in 1993 was 1.4 percent, while Poland maintained 11 percent tariffs in industry and 18 percent in agriculture (Feldmann 2007). On trade liberalization in Estonia, see also Feldmann and Sally (2002), Lindstrom (2005).

[331] There was a consensus in the transition literature that price liberalization, macroeconomic stabilization, and privatization must be implemented immediately after the collapse of a command economy (Blanchard et al. 1991).

[332] The government refused the loan from the IMF to balance the budget because it decided to construct the future of Estonia on "the momentum for radical reforms, not loans." Attracting foreign investments was considered to be a superior alternative to borrowing from international institutions because the latter preserves economic backwardness (Laar 2007: 4 and 6).

Managers of state-owned enterprises used price liberalization to make profits. Price liberalization resulted in rapidly rising output prices, but managers did not reevaluate the price of fixed assets or inventories. Because these enterprise assets were bought at cheap ruble prices, managers were suddenly able to make high profits and enrich themselves (Brown 1993: 498). However, the collapse of inter-republican trade and the currency reform had thrown incumbent enterprises into the competitive market economy environment, so these enterprises were putting pressure on the BOE for cheap credit. However, Kallas, the BOE governor, refused these requests for credit on the grounds that such a policy could undermine the currency reform (Knobl, Sutt, Zavoico 2002: 7, 11).

The rightist coalition government that was elected in September 1992, led by the Pro Patria Union with Mart Laar as Prime Minister, was the most effective in pulverizing the pre-independence nomenklatura coalition of state and party bureaucrats and managers of SOBs and enterprises, and in pursuing radical economic reforms.[333] It publicly proclaimed a "House Cleaning" campaign aimed at the vestiges of communist attitudes (Steen and Ruus 2002: 237). The government sent a clear message to all economic actors: "There is no point anymore in pinning hopes on former good relations with the ruling circles" (Laar 2002: 185). Estonian reformers were able to use the window of opportunity for dramatic change provided by the economic crisis at the outset of the transition, political independence, and weak rent-seeking interest groups to adopt a "home-grown" reform strategy (Feldmann and Sally 2002: 93). The principal lesson of the Estonian reform strategy was summed up by the advertising slogan: "Just do it," which meant being decisive about implementing

[333] The Laar's Pro Patria party was formed in 1991 from the fusion of several small Christian-Democratic conservative and right wing parties.

reforms and sticking with them in spite of the short-term costs that they cause (Laar 2007: 3).

Estonian authorities were determined to cut ties with incumbent interests from the socialist era and so they committed to rapid privatization of banks and enterprises early in the transition.[334] Privatization had begun before independence but early legislation on ownership reform in the Soviet period favored insiders, and the process bore signs of spontaneous privatization. In addition to joint ventures with Western investors, early efforts to escape the fetters of state ownership also included "small state enterprises," which were semi-private spin offs from state enterprises as well as so-called "peoples enterprises," an experimental leasing system for insiders similar to the Yugoslav-style of self-management (Mygind 2000: 7).[335] In addition, the growing independence movement pushed ownership reform toward restitution. Privatization was incorporated in the Estonian SSR government program, which came to power after the elections in March 1990, led by Savisaar. The privatization concept of 1990 emphasized direct sales with the participation of foreign investors, as the main form of privatization, necessary to create active owners. Privatization for money was also seen as a way to provide reserves for introducing the new Estonian currency (Terk 2000: 19–40).[336]

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[334] From the beginning, Estonian politicians refused to meddle in the economy. Even during the perestroika period, Estonia invoked the principles of private property as a way to attack the prerogatives of the Soviet state (Buyske 1997: 98). As former Minister of the Economy, Jaak Leimann explains: "Our liberal philosophy is due to the fact that we are so small and we just don't like state-owned industry" (Robinson and Vipotnik 1998: 2).

[335] When Soviet law in 1987 allowed state enterprises to seek partnerships and Western suppliers, Estonia established over 150 joint enterprises. These enterprises were later taken over mostly by foreigners. Moreover, over 2,000 new private cooperatives were established (Brown 1993: 494, Mygind 2000: 7). The Act on Small-Scale Privatization was adopted by the Supreme Soviet in December 1990.

[336] The banking law of 1989 has awarded the BOE quite extensive powers in privatization of enterprises. Article 9 of this law stated: "To ensure the stability of monetary circulation …a part of assets in the possession of the Republic of Estonia are given to the disposal of the BOE, including revenue from privatization, shares of state-owned joint-stock companies … The privatization of assets in state ownership shall be organized by a legal body at the government of the Republic of Estonia,

An important legal document for privatization was the Act of the Fundamentals of Ownership Reform adopted by the Estonian parliament in June 1991.[337] At the time the law was adopted, the Estonian Parliament favored voucher privatization (known as the political, or re-distributional approach), while the Savisaar government preferred direct sales for cash (called the economic approach). The nationalist policies in relation to the Russian speaking minority meant employee takeovers were not a favorable privatization option (OECD 1999). Although all parties were united in their commitment to reducing the state's role in the economy, disagreements regarding the actual implementation of privatization contributed to the fall of the Savisaar government in January 1992.[338] The Ministry of Economy took the lead in initiating the policy shift to asset sales at the expense of vouchers, in spite of the Parliament's opposition and the public's expectations of voucher privatization.[339] The Ministry of Economy had de facto practical responsibility for privatization because the State Property Agency in the Ministry of Economy established in 1990 to supervise privatization was part of its hierarchy. The BOE, the Ministry of Finance, and the Ministry of Industry also supported a direct sales method. The first seven large enterprises were experimentally privatized via asset sales between September 1991 and April 1992 (so-called pilot privatization) (Terk 2000).

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headed by a Supervisory Board. At least half the members of the Supervisory Board will be appointed by the Council of the BOE" (Terk 2000: 95-102).

[337] The following discussion of state and societal preferences in privatization policy relies on Buyske's account (1997: 95-110).

[338] The temporary government of Tiit Vahi, which was in power until the September 1992 elections, initially expressed its intention to comply with parliament's preferences for the voucher method. Legislation was adopted for the privatization of housing and agriculture using vouchers.

[339] Several factors influenced the choice of direct sales including the appointment of a new Minister of the Economy, Olari Tall, known for his managerial ability and Andres Bergmann, an Estonian with business experience in Germany as Deputy Minister. Both admired the achievements of the German privatization agency, Treuhandanstalt, which used the direct sales method in the former East Germany. Moreover, the CB put a premium on a balanced budget, and direct sales were seen as a way to increase budgetary revenues (Buyske 1997: 100-102).

Enterprise managers did not play an active role in privatization policy for several reasons. Those who had the most to lose from privatization were the Russian managers of the military and heavy industrial enterprises with political connections historically focused on Moscow. They were "disenfranchised" in terms of domestic influence by the policymakers and legislators in the independent Estonia. Estonian enterprise managers were frustrated with the Soviet command economy and expected that a free market environment and foreign investors would solve their problems. In addition, the hard budget constraints imposed by the government from the start of the transition was a clear signal to enterprise managers that privatization was their only option for financial survival.

The Laar government increased control over the privatization process. It merged the two existing privatization agencies into one Estonian Privatization Agency, put under the authority of the Ministry of Finance. A new Law on Privatization was adopted in July 1993. The policy of direct sales to "real" owners was "cemented" in September 1992, when the Estonian Privatization Agency, with the technical support of German consultants, adopted a privatization scheme modeled on the East German Treuhandanstalt scheme, which was based on auctions to outsiders.

This privatization strategy, coupled with very liberal foreign investment, trade regimes, and a 1992 strict bankruptcy law, which also applied to banks, created a system that provided foreign investors with many opportunities to enter the Estonian market (Feldmann 2007: 345). Incumbent enterprises were cut off from subsidies, and some were liquidated with their assets privatized (Mygind 2000: 10). A legal framework for foreign direct investments was adopted a few months after the country regained its independence in 1991, which turned Estonia into the "Hong Kong of Europe." Yet, the Estonian government did not provide selective incentives for

specific foreign investors and did not engage in activist industrial policy (Feldmann and Sally 2002).

The second stage of privatization started with the announcement of the first international tender for the sale of 38 enterprises in November 1992 (Ennuste et al. 2004: 16). Large enterprises were sold directly to "core" investors using open tenders that were followed by negotiations on restructuring and new investment. Foreign owners were already playing a prominent role in that process and acquired around 40 percent of the sale value of all privatized enterprises by the end of 1994.[340] Foreign investors were interested in macroeconomic and currency stability and the CB greatly contributed to this (Korhonen 1999: 17). The pace of privatization was remarkable: over half the enterprises were privatized within less than a year and half (1993–1995) (Laar 2002: 262). Large-scale enterprise privatization to strategic investors was successfully completed in mid-1996 (Barisitz 2002: 87).

At the end, the voucher method that began late 1994 was used but only marginally to make people part of the property transformation process and to create a stock exchange.[341] Vouchers were primarily used for privatizing housing but from the end of 1994 it was also possible to use vouchers to buy minority shares in some large enterprises but only after majority shares were already sold to a core, usually foreign, owner.[342] Banks were not privatized through the voucher method.

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[340] For 1997 and 1998, foreign capital paid more than 50 percent of the total revenues of the Estonian Privatization Agency (Mygind 2000: 9).

[341] At the end, Estonian privatization was a synthesis of different models, uniting the advantages of East German and Czech models while avoiding their shortcomings. Author's interview with Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999-2002), July 19, 2007, Tallinn.

[342] In contrast with the Czech Republic, investment privatization funds did not have any formulated role in Estonian legislation. In June 1996, there were 6 investment funds that amassed only 1 percent of the total value of distributed vouchers (Mygind 2000: 10).

In sum, the aim of Estonian reformers was rapid property transformation with the goal of attracting foreign investors into the banking and enterprise sectors. Large-scale privatization involved a high political consensus and the participation of opposition party representatives on the boards of institutions that carried out privatization, which pushed aside the former nomenklatura and its cronies (Ennuste et al. 2004: 18). A stable national currency was considered a crucial precondition for foreign investment and privatization (Brown 1993: 496).[343] In the next section, I will discuss how privatization policies of banks and industries impacted financial system development and the ability of Estonian monetary authorities to sustain strong commitment to stable currency policies.

Financial Development Phase I: The First Banking Crisis (1992–1993)

Banking reform in the Soviet Union started in 1988, when the Soviet monobank system was reorganized into a two-tier banking structure, consisting of Gosbank (the State Bank of the USSR) and specialized SOBs: Sberbank (Savings Bank), Agroprombank (Agricultural Bank, later Maapank), Promstroibank (Industry and Construction Bank), Zhilotsbank (Residential Construction and Light Industry Bank, later Social Bank), and Vneshekonombank (Foreign Trade Bank, later renamed the North Estonian Share Bank, NESB).[344] The first new private bank in Estonia (and in the ex-Soviet Union) was the Tartu Commercial Bank (Tartu Kommertspank, TCB) created in December 1988. The shareholders of the bank were mainly Estonian state-owned enterprises (Sorg 1998: 169).[345] In December 1989, the Estonian Supreme

[343] For a comprehensive analysis of the privatization process in Estonia, see Terk (2000).
[344] Before World War II, the Republic of Estonia had a banking system with the central bank and three types of financial institutions: universal commercial banks, city banks, and savings and loan associations (Sorg 1998: 168).

[345] TCB permitted several shareholders to establish branches, which were de facto economically independent. In this way, the Tallin Commercial Bank, Virumaa Commercial Bank, West-Estonian Commercial Bank, and Otepää Innovation Bank were established.

Council adopted the banking law, which reestablished the BOE as the central bank of the Republic. The law, however, contained both command and market economy elements and because the Soviet ruble was Estonia's currency at that time, the BOE's authority was confined to monitoring banks (Hansson 1995: 148, Barisitz 2002: 85).

In the chaotic institutional and hyperinflationary environment prior to monetary independence, banking became a lucrative business. Most SOBs earned most of their profits from foreign currency speculations and short-term foreign trade arbitrage transactions between the USSR and the West (Barisitz 2002: 85). During the cash crisis period, arbitrage of the various prices for cash and non-cash rubles represented considerable profit-making opportunities.[346] With lax or nonexistent banking regulations and supervision, related mainly to confusion concerning the licensing policies of dual power in Estonian banking (the BOE and Gosbank) from autumn 1988 to June 1992, few restrictions were placed on such speculations (Hansson 1995:147). The Estonian branch of Gosbank practically stopped the supervision of banks on Estonian territory in 1989 (Sorg 1998: 170).

Licensing requirements were relatively lax and minimum capital requirements were set at only 5 million rubles (fewer than 40 thousand U.S. dollars in 1992 figures). Hyperinflation further reduced the real value of the obligatory initial bank capital. As a result, big state owned enterprises, enriched by speculations in a weakly regulated environment, were able with little money to create their own banks (the so-called "pocket banks") or grab the branches of all-Union banks and use them to pump resources to finance their activities. The initiative also came from a former communist nomenklatura with close political links with the managers of incumbent banks. In

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[346] Banks tried to increase their cash reserves to be able to speculate. While at the beginning of 1992, banks held 176 million rubles in cash, they already held 768 million rubles on the eve of the monetary reform (Sorg 1994: 14).

many cases, owners, managers and the state were the same or closely related persons, making it hard to separate these parties (Sorg 1998: 170–172). Creating their own banks allowed enterprises to gain better access to the Soviet Gosbank's credits, which were inexpensive by their low interest rates in a hyperinflationary environment (Hansson 1995: 147). These factors led to a proliferation of new private banks. By the end of 1992, 25 new banks had been licensed and 43 banks were registered (Fleming 2001: 90).[347]

Incumbent banks with substantial bad loan portfolios and mismatches on their balance sheets were able to remain liquid by using their large profits from foreign exchange trading or by re-lending cheap central bank credits at high interest rate spreads (Hansson 1995: 150). Laar (2002: 184–185) characterized the situation in the initial stages of transition in the banking sector as follows:

> The former Communist party bosses considered it only fair to compensate the loss of their high status by taking up positions in banks, knowing at the same time absolutely nothing about banking. Very soon they started trying to go about their business in the banking world in the same way as they had in the Communist party, by cheating and lying, and taking all the benefits for themselves and their friends. But you cannot get very far using those kinds of methods in a market economy. The bankers fell back on their earlier experiences and tried to shift the blame for their errors and mistakes onto the Estonian state, hoping that the new young government would give in to their demands as easily as previous governments. In this situation, even indecisiveness would have been a decision, one which would probably ultimately have led to the fall of the kroon.

[347] Banks were however, very small. For example, 11 banks had fewer than 10 shareholders and two banks had only one shareholder (Sorg 2000: 403).

The independence of Estonia in 1991 resolved the problem of the co-existence of two central banks that were creating confusion about whose laws took precedence. The Estonian branch of Gosbank was taken over and integrated into the BOE in 1992 (Hansson 1995: 147–148). Subsequently, the Law on the BOE, granting it a high degree of legal independence, took effect in June 1993.[348] Monetary reform unified the exchange rate, reduced buy-sell spreads, and thus decreased foreign exchange revenues of banks (Hansson 1995: 150).[349]

As inflation declined, the repayment of loans diminished, which caused liquidity problems in several banks. Banks misjudged the resolve of the BOE concerning bailouts. The BOE remained faithful to the policy of the "hard kroon" and renounced bailing out the banks to save them. Illiquidity problems, coupled with the freezing of assets in two big banks in Moscow, triggered a banking crisis in November 1992. The BOE announced a moratorium on the three largest banks: TCB, which had a mixed ownership (government, co-operative, and private), Union Baltic Bank (Balti Uhispank, UBB) and NESB (Pohja-Eesti Aktsiapank), owned by the BOE. During the moratorium period, the BOE faced significant pressures for protection from the management and shareholders of these banks. The UBB Chairman demanded that the BOE devalue the currency by forty percent in order to support his bank.[350] The principal sources of problems were, however, not the same for all three banks.[351]

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[348] In fact, the BOE itself drafted the new banking law. It requested input into the rafting process from the Estonian Bankers' Association, the Ministry of Finance, the Ministry of Justice, and the Ministry of the Economy, but the BOE made all of the final decisions. The BOE considered the involvement of the bankers association as a way to ensure acceptance of the law by the banks, not as a joint legislative effort (Buyske 1997: 113-14).

[349] In the first half of 1992, 63 percent of bank revenues came from foreign exchange trading. After the monetary reform, this share decreased to 39 percent (Sorg cited in Hansson 1995: 150, fn. 20).

[350] *The Baltic Independent*, November 27–December 3, 1992.

[351] The Savings Bank, which placed 25 million U.S. dollars in assets in Moscow, was also affected. Because it held over 85 percent of household savings at the time, the BOE took over its ownership. The BOE swapped some of its own assets for the Saving Bank's claim on the Moscow Savings Bank to

Liquidity problems of TCB stemmed from losses on foreign exchange speculations and problems with bad loan portfolios. Prime Minister Laar warned that the ultimate solution to the banking crisis would be harsh, stressing that the planned 1993 budget did not have enough money for a bailout (Hansson 1995: 151). Therefore, the BOE, supported by the Laar government decided to liquidate TCB against IMF advice.[352] The government feared the links with organized crime in Russia of shareholders and bank customers (Laar 2002: 188). The BOE took a different approach to the other two banks, for their problems were caused mainly by the frozen foreign currency assets in Moscow.[353] UBB froze all accounts of state-owned enterprises and attempted to force the government to deal with the problem of frozen assets. UBB and NESB were forcibly merged into a new bank, the North Estonian Bank (NEB) and recapitalized by the central bank.[354] The BOE approach to the bankers was succinctly summarized by "Commercial Banks, Kallas, Kroon: Who is Stronger?"—an article in the Estonian newspaper, *Rahva Haal* (Buyske 1997: 85).

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minimize disruption of public confidence during the planned monetary reform and to protect population savings (Fleming 2001: 91).

[352] The IMF was concerned about a systemic banking crisis and suggested instead a merger of all three banks into a single unit. This proposal was refused by both the BOE and the government on the basis of the argument that this solution would not take into account different causes of bank problems and would require more resources from the state budget. TBC's assets were sold at auction, the depositors received about 60 percent of their deposits, and shareholders, responsible for the mismanagement of the bank, were not compensated. Author's interview with Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999–2002), July 19, 2007, Tallinn.

[353] NESB and UBB placed 40 million U.S. dollars and 36 million U.S. dollars with the Vnesheconombank, and were thus badly affected when the Moscow offices of Vnesheconombank froze foreign exchange deposits in early 1992 (Fleming 2001: 91).

[354] The original BOE proposal envisaging unchanged ownership structure of banks was refused by the government, which feared that it would be too favorable to incumbent owners of the bank responsible for banking problems (Hansson 1995: 152-153). Thus, the BOE and the government created a Vnesheconombank-fund (VEB-fund), which issued certificates backed by the frozen assets held in Moscow. The shareholders were given VEB-fund certificates in lieu of their shares, and thus virtually nothing. The government also exchanged the valueless VEB-fund bonds from the new bank for government bonds. Finally, the government added additional bonds to strengthen the NEB's balance sheet, and in return took 100 percent ownership of the bank (Fleming 2001: 99).

After the banking crisis was resolved, the BOE announced a stabilization period: it established a licensing review and froze the issuance of new bank licenses with the rationale that some banks received their operation licenses from Moscow and were established before BOE existed. As a result, eight banks were not renewed for the license, ten banks merged into Union Bank of Estonia (UBE), and three banks declared a moratorium. By 1994, the number of banks in Estonia decreased from 43 to 21. The biggest banks included the Social Bank (Eesti Sotsiaalpank), Hansapank, UBE, Savings Bank, and NESAB. The BOE used this opportunity to further strengthen banking regulations.[355]

Nonetheless, this was still not enough because of the insolvency problems of the largest bank, the Social Bank, which was the government's main fiscal agent financing the oil and metal trade.[356] The root cause of the bank's problems resulted from connected lending to small shell enterprises: the owners were distributing large loans among themselves at very low interest rates (Laar 2002: 193, Sorg 1998: 174). Although the eventual liquidation of the bank did leave a residual tough message, the interim efforts of the BOE to provide liquidity support and to seek other ways of saving the bank diluted this message (Fleming 2001: 92). The government used this event to adopt a new Credit Institutions Act in December 1994 that further increased the BOE's supervision and enforcement powers.

Bankers were angry at the decision of monetary authorities to liquidate them. They promised that the government would go down in three weeks. But the authorities

[355] A condition for renewing banking licenses was to meet a schedule for a gradual rise in minimum liquidity capital to 5 million ECU. In 1993, new prudential requirements were established, including capital adequacy ratio (8 percent, increased later to 10 percent), liquidity ratio (30 percent), minimum equity requirement (15 million Kroons, increased to 35 million Kroons by April 1997), and the maximum loan to a client not exceeding 50 percent of the bank's equity (Sorg 1998: 173-4).

[356] In 1993, the Social Bank represented about 20 percent of the country's total commercial bank assets.

were firm and did not want to "waste any cent of state money on saving the banks."[357] The BOE's president, Siim Kallas, was also consistently firm in his commitment to face interest group pressures to limit the independence of the central bank:[358]

> Some industrial circles, often connected with the former Soviet *nomenklatura,* have tried to force the Bank of Estonia to issue more kroons without proper backing. This could enable them to continue as before the production of expensive and low quality goods that have no market. The Bank of Estonia will never yield to such pressure.

Nor has the BOE yielded to calls by the Ministry of Justice to overturn the central bank law to subordinate it to Estonia's economic policy on the grounds that the existing law "turns some functions of executive power over to the BOE" (Staprans 1994: 9). Although there have been occasional signs of dissent, the Estonian Parliament has been supportive of the CB and its implications for monetary policy and the BOE's independence (Buyske 1997: 89).[359]

In sum, with the introduction of the CB, the BOE simultaneously declared its unequivocal position that it would not help troubled banks to counter moral hazard behavior in which banks counted on government rescues and engaged in consolidation and privatization of the banking sector. The BOE refrained from intervention, in spite of the fact that the CB allowed well-defined bank rescues as long as its foreign reserves remained above base money liabilities, which was the case in the banking

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[357] Author's interview with Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999–2002), July 19, 2007, Tallinn.

[358] "Estonia: Monetary Reform, Hard Style," Interview with Siim Kallas in: *The Baltic Review,* Vol. 1, No. 3, 1993:41.

[359] There were some political proposals to unite the state and the central bank budgets that would have restricted BOE independence and subordinated it to the government in fall 1993. The likely outcome would have been that any surplus in the BOE's budget would have been available to finance the government (Sorg 1994: 10).

crisis in 1992–1993 (Hansson 1995: 152). Instead, the Estonian monetary authorities choose to close down large incumbent banks, which was a politically bold step for showing their resolve to discipline powerful financial interests in order to sustain their commitment to the CB.

The steadfast approach of the BOE and the government in dealing with the banks unable to operate on sound principles and laid the groundwork for a competitive banking sector. Both domestic and foreign banks had to adjust their behavior early on and became supporters of the government's anti-inflationary crusade and policy of a strong kroon. As the Chairman of Hansapank expressed, "On balance, I am in favor of the 8:1 [Estonian kroon to *Deutsche mark*] parity, because currency stability controls inflation and encourages time deposits," even though it hurt the banks by holding back the creation of new money.[360]

Financial Development Phase II: The Second Banking Crisis (1998–1999)

After being corporatized in 1990 (that is, transformed into joint stock companies), most former specialized SOBs were (indirectly) privatized as a result of the privatization of their owner enterprises (Barisitz 2002: 87). At the same time, the government lifted restrictions on foreign investments in the Estonian banking sector (Sorg 1994: 11). While the government allowed foreign strategic investments in the banking sector right from the beginning with the intention of privatizing Estonian SOBs to well-known foreign banks, there was a lack of interest from foreign financiers in the initial stages of the financial reforms. The government in turn, did not have financial resources to re-capitalize SOBs to make them more attractive for privatization.

[360] "New Central Bank Leads the Way." *Euromoney*, June 1993: 164.

Thus, only a few foreign banks established their operations in Estonia initially. There were some early (unsuccessful) foreign bids and a few foreign enterprises bought shares in Estonian banks. [361] Nonetheless, the entry of new private banks and privatization of parts of former SOBs contributed to a "pluralistic" ownership structure already in the initial stages of financial development (Hansson 1995: 157, 161). Therefore, although foreign banks were cautious about entering the Estonian banking sector in the initial years in spite of liberal policies for foreign direct investment in the banking sector, the government's role in finance declined sharply. In 1996, the EBRD reports that the share of assets of SOBs of total banking assets represented only 6.56 percent.

In this new institutional environment with strong regulation and competition, banks usually did not lobby the BOE directly but tried to find weaknesses in banking regulations for profit making opportunities. Although there were some rare occasions when banks lobbied for favorable laws like the Deposit Insurance Law, or the acquisition of control packets of shares in the enterprises selected for privatization, the BOE was able to constrain their ambitions in the end.[362] Because enterprise privatization progressed fast, among the main supporters and sometimes initiators of the banking reforms were newly privatized and private enterprises, whose activities were the most severely hindered by the post-Soviet banking system (Sorg 1994: 4).

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[361] American Bank of the Baltics (Ameerika-Balti Uhispank) with the U.S. owner received a license in 1992 and INKO Baltic Bank, a subsidiary bank of the Ukrainian bank in 1994. In autumn 1997, the German Schleswig-Holstein Landesbank expressed interest in acquiring shares of the Estonian Investment Bank (Eesti Investeerimispank) but met the resistance from the management, wishing to continue as an investment bank and not to be transformed into a retail bank (Sorg et al. 2004: 266).

[362] When the Law on Deposit Insurance was being prepared, the six major banks suggested an alternative system, where their contribution tariff would be lower due to their lower risk rate. But this proposal contrasted with the BOE's approach envisaging an equal contribution rate for all banks. Although the BOE at the end did not accept the proposal of the largest banks, its draft for this law was stuck in the coordination stage for more than two years before it reached the Parliament. Deposit Insurance Law finally took effect in October 1998 (Sorg 1998: 176).

In the years following the first banking crisis, Estonian banks started to expand their activities into Russia, Ukraine, and other Baltic states, where interest rates and profitability were higher, for Western foreign banks were still not interested in entering those markets. Hansapank was the most successful in establishing an extensive network of subsidiaries in all Baltic countries.[363] Estonian banks also started to operate in non-banking businesses and established independent investment funds to speculate on the domestic securities market because they were too small to operate on international financial markets (Sorg and Uiboupin 2002). In contrast to their Czech counterparts, Estonian bank investment funds were small players because privatization was pursued mostly through direct sales and free bidding, and did not influence bank lending policies.[364]

The Asian crisis of 1997–1998 and the 1998 Russian crisis represented severe tests for the Estonian financial system, its CB and its high degree of openness. The burst of a market bubble on the Tallinn Stock Exchange and the pressures on the kroon due to contagion from the Asian financial crisis significantly reduced bank profits. Several banks started to experience liquidity problems (Sorg and Uibopin 2004: 97). Although the 1998 Russian financial crisis did not hit Estonian banks directly because they were not heavily invested in Russian debt instruments, they were hurt by the general economic slowdown. Therefore, in contrast with the first banking crisis, in which the roots of crisis were domestic, the second banking crisis in 1998–1999 was of an international nature (Sorg 2000: 406).[365]

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[363] In 1996, Hansapank acquired Latvian Bank (Deutsche Lettische Bank), which had defaulted. The name of the bank was changed to Hansapank–Latvia. In 2001, Hansapank controlled about a fourth of the entire Baltic banking sector in terms of assets (Adahl 2002: 112).

[364] Author's interview with Raul Malmstein, Chairman of the Management Board, Financial Supervision Authority, July 17, 2007, Tallinn.

[365] On Estonian banking crises, see Berensmann (2002: 233-4).

As before, the BOE reacted to the banking problems with six mergers into larger banks, three bank bankruptcies, and continuing bank privatization. Aare Järvan, the Head of the Policy Department of the BOE, noted that banks had gotten too careless again and that a small crisis suited them well (Sorg and Uiboupin 2004: 101). At that time, the BOE had a strong supporter of liberal financial policies at the Ministry of Finance, for the former head of the BOE and "father" of the kron Kallas took the finance ministry portfolio when Laar returned to the Prime Minister's seat (after losing a vote-of-confidence in 1994). This second wave of bank restructuring reduced the number of banks from eleven to six.

The government also continued to privatize domestic banks to foreign investors. The story of the Estonian financial system since the mid-1990s has been one of growing involvement of foreign, mainly Scandinavian, banks. Swedish and Finish banks took over most Estonian banks. The major Swedish banks, Swedbank and Skandinaviska Enskilda Banken (S-E Banken), managed to buy the cheapened shares of the two major Estonian banks facing financial difficulties on the stock market Hansapank and UBB (59 percent and 32 percent). The Finnish Sampo group acquired Optiva Bank (resulting from the merger of the Estonian Investment Bank and Forekspank).[366]

Thus, while during the first banking crisis, the domestic monetary authorities had to resolve bank problems, during the second banking crisis, foreign banks assisted in putting the Estonian banking system in order (Sorg and Vensel 2001). By the end of the 1990s, the privatization of Estonian SOBs by foreigners was completed. Currently, foreign banks control 97 percent of the Estonian banking sector. The state had fully dispensed with its majority ownership shares in domestic banks. An open financial

[366] Finish banking group Sampo controls 7 percent of the market through ownership of Sampo bank and Merita Nordbanken has a branch in Estonia, controlling 6 percent of the market (Sulling 2002: 483).

system has been associated with a decrease in nonperforming loans from 3 percent to below 2 percent and inflation from nearly 11 percent to 5 percent over the period 1997–2001 (Adahl 2002).

The Estonian authorities again used this crisis to reinforce further the regulatory and supervisory institutions. The government created a unified (banking, insurance and securities market) financial supervision, which was taken over by the Estonian Financial Supervision Authority in 2002 following the German model.[367] The takeover of Estonian banks by Swedish and Finnish banking groups was also accompanied by substantial capital and liquidity injections and improvements in the banks' supervision and risk management. The foreign ownership of Estonian banks by much larger Scandinavian groups has been considered to be an implicit guarantee of capital supply and a substitute for a lender of last resort (Adahl 2002: 112).[368]

In sum, rapid divestiture of state ownership in the banking as well as in the enterprise sector has proved important for developing an open financial system in Estonia, based on a formal and arms length relationship between the financial sector and the state. The divesture has led to intensified competition, increasingly stronger regulation and supervision, improved transparency, and trust building by the banks themselves. It quickly decreased profit opportunities from speculative activities,

[367] Previously, financial supervision was carried out by three institutions. The Banking Supervision Department of the BOE performed the supervision of credit institutions. Supervision of the insurance sector was undertaken by the Insurance Supervisory Authority, a financially independent organization under jurisdiction of the Ministry of Finance. The securities market was supervised by the Securities Inspectorate under the jurisdiction of the Ministry of Finance. Author's interview with Raul Malmstein, Chairman of the Management Board, Financial Supervision Authority, July 17, 2007, Tallinn. See, also Eesti Pank (2001).

[368] On the other hand, supervisory authorities in Estonia and in the Scandinavian countries can be faced with a "too small to fail" problem. Since the Estonian banks are very small compared to the parent banks, they do not pose any threat to financial stability in the country of the parent banks. Therefore, the supervisory authorities in the parent banks' country have weak national incentive to assume responsibility for supervising the systemic risks in Estonia, despite the fact that the parent banks are expected to take responsibility for an eventual systemic crisis. This enhances the need of the Estonian supervisory authorities to keep track of the financial strength of parent banks (Adahl 2002).

disciplined bank behavior and enabled the BOE to strengthen its independence and credibility.

Bulgaria

The Inconsistent Path to Economic Reforms (1991–1996)

In contrast to the rather cumulative reform trajectory of Estonia, the financial crisis of 1996–1997 divided Bulgaria's experience with economic transition into two contrasting periods, both associated with different exchange rate policies. A pro-Soviet atmosphere of Bulgarian communism and the absence of strong opposition left the population largely unprepared for radical economic reforms.[369] The inherently vulnerable macroeconomic context was further compounded by political instability and the nature of the country's distributional conflicts.

The absence of a strong opposition in 1989 led to a political victory of the ex-communists—the Bulgarian Socialist Party (BSP)—in the first free elections in June 1990 with Andrei Lukanov as Prime Minister.[370] As a concession to the opposition, the leader of the Union of Democratic Forces (UDF), Zhelyu Zhelev, its Chairman and Bulgaria's leading dissident, became the first democratically elected president.[371] The BSP promised to carry out a protectionist program, but the first Socialist government was unable to decide on and implement any coherent set of economic reform policies

[369] Author's interview with Veselin Mintchev, Bulgarian Academy of Sciences, Institute of Economics, June 27, 2007, Sofia.

[370] The political change in Bulgaria began on November 10, 1989, when the communist leader Todor Zivkov was ousted in a palace coup after his eighteen-year rule. The communist party was renamed the BSP in January 1990. In June 1990 elections, the BSP gained an absolute majority of 211 of 400 seats (Vachudova 2005: 42).

[371] The first elected socialist President, Petar Mladenov, had to resign soon after the elections, when it was shown that at the height of the December 14, 1989 demonstrations, he had said to an aide: "It's time to send in the tanks." Author's interview with Georgy Ganev, Program Director for Economic Research, Center for Liberal Studies, June 29, 2007, Sofia. See also Koford (2000).

(Koford 2000: 324).[372] The second elections in October 1991 brought a small plurality in the parliament to the UDF, which formed a minority government supported by the ethnic Turkish Movement for Rights and Freedoms (MRF).[373] The UDF-led government of Prime Minister Filip Dimitrov was largely responsible for implementating the initial liberalization reforms (table 6.3). It embarked on economic reforms in February 1991 when it launched a stabilization program, attached to the one-year stand-by-agreement with the IMF, similar to the one adopted in Poland in 1990 and in Czechoslovakia in 1991 (Dobrinsky 2000: 583).[374] The reform program envisaged the reduction of the budget deficit, the unification of the exchange rate, and the attainment of a current account surplus.

Price liberalization led to high inflation that reached 474 percent at the end of 1991 (Berleman, Hristov, and Nenovsky 2002: 18). Notwithstanding, in contrast to Poland and Czechoslovakia and in spite of high inflation, Bulgarian authorities adopted a managed float regime and a money-based stabilization program. In 1990–1991, the main proponents of the Estonian CB, Stephen Hanke and a team of U.S. economists suggested a CB (with the currency pegged to a basket of goods and not to a foreign currency) as the initial exchange rate regime to the Bulgarian authorities, as well. This proposal was rejected by the IMF, however, which was

[372] Lukanov resigned under the influence of mass protests and the interim non-partisan government led by Dimitar Popov was nominated by UDF. Popov delayed some economic reforms by focusing predominantly on a new constitution (Stone 2002: 211).

[373] The UDF that grouped historic social democratic and Christian democratic parties, ecological movements, a trade union, religious, and human rights groups, announced its existence on November 23, 1989. In the second elections, the UDF won 110 seats, the BSP 106, and the MRF 24 (Vachudova 2005: 40).

[374] Bulgaria signed its first stand-by agreement with the IMF in February 1991. It consisted of two tranches: the first in the amount of 394 million U.S. dollars and the second in the amount of 131 million U.S. dollars (Wyzan 1998: 13).

Table 6.3: Governments in Bulgaria, 1990–2002

Duration of Government	Prime Minister	Party affiliation of Prime Minister	Cabinet Type
November 8, 1991–December 29, 1992	Philip Dimitrov	Union of Democratic Forces	Minority
December 20, 1992–October, 17 1994	Ljuben Berov	Non-party government	Technocratic
October 18, 1994–January 24,1995	Reneta Indjova	Independent	
January 25, 1995–February 11, 1997	Zhan Videnov	Bulgarian Socialist Party	Majority
12 February 12, 1997–May 20, 1997	Stefan Sofianski	Union of Democratic Forces	
May 21, 1997–July 23, 2001	Ivan Kostov	Union of Democratic Forces	Majority

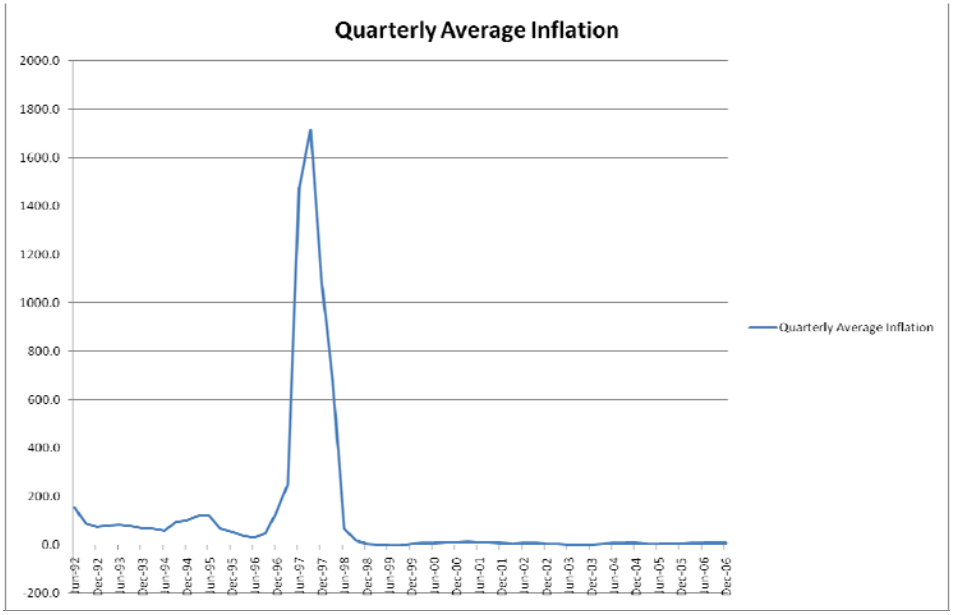
reluctant to support the CB that would not be fully backed by foreign reserves as well as by the Bulgarian National Bank (Blgarska Narodna Banka, BNB). BNB Governor Todor Vulchev, elected in January 1991, provided the limited foreign exchange reserves as the main reason behind the decision to float (table 6.5). High indebtedness and debt moratorium were cited as additional factors by the CB opponents.[375]

The initial choice of the currency regime was, however, a political issue, not simply a matter of insufficient international reserves. A float was a desirable regime arrangement for powerful financial interests because they favored inflation instead of stable money and prices, and were thus unwilling to support restrictive monetary policy.[376] A flexible regime allowed the central bank to continue its policy of high inflation. A genuine commitment to price stability would have needed to be supported

[375] Author's interview with Lena Roussenova, former Member of the Governing Council of the BNB, June 22, 2007, Sofia. See, also Hanke and Schuler (1991).

[376] Author's interview with Tsvetan Manchev, Deputy Governor of the BNB, June 26 and July 2, 2007, Sofia.

by a more rigid exchange rate arrangement such as a fixed regime or CB, as former Chief Economist of the BNB, Lubomir Christov (1997: 140) underlines. However, in contrast with Estonia, a political will to commit to a more rigid exchange rate or to price stability was missing in Bulgaria. A flexible regime also allowed the government to pursue a policy of depreciated currency to support uncompetitive state-owned enterprises as well as to depreciate government and bank debts.[377] Prior to the 1996–1997 crisis, no Bulgarian government tried to implement anti-inflationary policies based on a credible fixed exchange regime. Exchange rate and monetary policies remained dominated by incumbent government banks and enterprises, which continued to siphon resources from the state.



Source: Bulgarian National Bank.

Figure 6.1: Quarterly average inflation, June 1992–December 2006

[377] Author's interview with Kalin Hristov, Advisor to Governor of the BNB, June 21 and 27, 2007, Sofia.

In a similar vein, no Bulgarian government was able to develop and implement a clear policy of bank and industry privatization, either. Although Prime Minister Dimitrov promised that his UDF-led government would be the "government of privatization," the UDF was unwilling to compromise with the MRF and the BSP. Instead, it opted for the repeated bailouts of financially problematic state-owned enterprises and banks through BNB credits (Stone 2002: 213).

The privatization process was subject to sharp political controversies. Except for some special pieces of legislation passed in 1992, including the Transformation and Privatization of State and Municipal Enterprises Law, and the establishment of the Privatization Agency (subordinated to the Council of Ministers) little, if any, progress in privatization was achieved in the early years of transition. Instead, members of the former communist nomenklatura conducted an informal "quiet" and "illegal" privatization, attempting to divert to their private ownership a part of the state assets under their managerial control (Frydman, Rapaczynski, Earle et al. 1993: 24–35).[378] Only 5–7 percent of state enterprise assets were privatized between 1992–1997 (Miller and Petranov 2000: 227).

It has been argued that the fundamental disagreements over privatization between the BSP and UDF, rather than the obstruction of the socialists, caused delayed privatization of banks and industries (Barnes 2007: 80–81). Ironically, the BSP and UDF were arguing for mass privatization on opposite ideological positions than their counterparts in the Czech Republic. While in the Czech Republic radical

[378] "Quiet" privatization relies on legislation, which do not provide for open and public divestiture of state property, while "illegal" privatization involves breaching existing legislation. For example, according to Article 13 of Decree No. 56 on Economic Activity, which was in force between May and August 1990, the management of state-owned enterprises was allowed to sell "fixed assets to physical and juridical bodies" without specifically defined auction procedures. These sales resulted in an extensive transfer of state property to private enterprises and individuals belonging to the networks of communist nomenklatura (Frydman, Rapaczynski, Earle, et al 1993: 34-35).

neoliberal reformers of the Klaus right wing party pushed for voucher privatization, in Bulgaria, it was the socialists who underlined its egalitarian character. The right-wing UDF was concerned that mass privatization would create widely dispersed ownership and weak governance of newly privatized enterprises, and thus favored a slower, direct sales approach. However, a very limited cash privatization occurred before 1996. In addition to inter-party conflicts over the proper course of privatization, an additional reason for delayed privatization was that one of the key partners of the UDF coalition was the trade union Podkrepa, whose leadership strongly opposed privatization because it feared that it would lead to termination of subsidized wages and liquidation of enterprises (Stone 2002: 230).[379]

When the economic situation started to deteriorate rapidly, privatizing and liquidating inefficient enterprises became more urgent as a way to solve the problem of lack of public confidence in government. Therefore, the BSP government launched the first wave of a voucher privatization program in January 1995 to provide the population with pieces of property (Table 6.4).[380] Although patterned on the Czech mass privatization, the design of the Bulgarian program differed in several aspects, benefiting from its later implementation when some of the deficiencies of the Czech program started to become visible.[381]

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[379] The Podkrepa confederation of trade unions, founded in 1990, played a crucial role in bringing down the BSP Lukanov government in 1990 and helped to force the resignation of another BSP government led by Videnov in 1996-1997, as described below (Sharman 2004: 807).

[380] Vouchers were sold to citizens over 18 for a nominal fee of 500 lev (per capita monthly wages at the time were about 9,800 lev). Vouchers were transferable to privatization funds that could use them to bid in national auctions. Although more than one-fourth of state enterprises participated in the first privatization wave, most large enterprises were only partially privatized and the state retained majority control (Miller and Petranov 2000: 227-228).

[381] The following description of the differences between the Czech and Bulgarian voucher privatization is based on Miller and Petranov (2000: 228-234) and Koleva and Vincensini (2002). For a detailed examination of Bulgarian privatization, see also Pamouktchiev, Parvulov, and Petranov (1997).

First, banks were not privatized in the mass privatization program. While they sponsored nineteen investment privatization funds (IPFs), they did not pay much attention to the voucher program, for many of them started to experience severe liquidity problems (Miller and Petranov 2000: 231). Second, before implementing the voucher program, Bulgarian authorities established strict regulatory institutions for licensing and monitoring investment privatization funds, including the Securities and Stock Exchange Commission to oversee and regulate new stock markets.[382]

Funds were not allowed to be invested in one another without special permission. Legal restrictions were established that prohibited banks or enterprises with more than 50 percent state ownership to found or to become shareholders in privatization funds. Because banks were not included in voucher privatization, IPFs were not allowed to own the banks. These measures prevented cross-ownership webs among banks, enterprises, and the state that arose in Czech lands. Third, although foreigners were not permitted to bid directly in the auctions, they acquired control of enterprises by buying shares directly from IPF representatives who were present at the auctions (Miller 2006: 19).[383]

[382] As a result, the number of privatization funds in Bulgaria (81) was much smaller than in the Czech Republic (over 400), mainly because of stricter registration requirements.

[383] In the original mass privatization program, a second wave similar to the first one was envisaged but the 1996–1997 financial crisis stopped the process. The post-crisis UDF government resisted mass privatization. The second wave finally began in July 1998 but on a much smaller scale than the first. The majority of privatization funds established during the first wave were converted to investment holding companies (76 out of 81) and their shares are traded on the Bulgarian Stock Exchange.

Table 6.4: Voucher Privatization: A Comparison of the Czech and the Bulgarian Experience

	Bulgaria First wave	Czech Republic First wave	Czech republic Second wave
No. of citizens eligible (ml.)	6.5	7.6	7.6
No. of participating citizens (ml.)	3.0	5.9	6.2
Participating/eligible ratio (%)	47.0	77.6	81.6
Number of voucher books transferred to private funds (ml)	2.4	4.3	3.9
Number of voucher books transferred/total number ratio (%)	80.5	72.8	62.9
Number of investment privatization funds	81	265	350
Founders of investment privatization funds	State financial institutions, managers or public officials, private industrial and/or financial companies, physical persons	State financial institutions, private financial or non-financial agents	
Cross-ownership between banks and funds	Discouraged by regulation and limited development	Unintended and widespread	

Source: Miller and Petranov (2000: 229), Koleva and Vincensini (2002: 85).

The delay of privatization created a power vacuum and allowed rent seeking by enterprise managers and state officials. The Bulgarian authorities did not impose hard budget constraints on the activities of state-owned enterprises, which accumulated payment arrears and continued to subsist on generous government subsidies and credits from the central bank (Dobrinsky 2000: 588).

Financial Development Prior to 1996: the "Credit Millionaires"

During most of the communist period, all banking functions were the responsibility of the BNB, a monobank created by a nationalization process in 1947 in

which all existing commercial banks were merged.[384] The BNB was under direct control of the Council of Ministers. Besides the BNB, there were only two other banks during the communist period: the State Savings Bank (Durzhavna Spestovna Kasa, DSK), the only bank allowed to hold the accounts of individuals, and the Bulgarian Foreign Trade Bank (now Bulbank), which was in charge of all foreign exchange operations for the country. Late in the socialist period (mid-1980s), the government introduced changes in the financial sector that created rent-seeking opportunities for a group of politically connected entrepreneurs and party officials who quickly infiltrated the newly developed banking system (Stanchev 2001: 3).[385] In 1987, specialized, sector-specific banks were created, each restricted to lending to a particular sector (the chemical industry and transportation, for example), including Biohim, Elektronika, Transportna Banka, Zemedelska i Kooperativna Banka, Transportan Technika (later Balkanbank), Stroibank, and Stopanska Banka (Miller and Petranov 2001: 11). These banks were owned by sectoral ministries, the largest enterprises in their sectors, and the BNB, which initially owned a controlling share in each bank (Barnes 2007: 77).

Following the political changes of 1989, the banking system was transformed into a two-tier system of the central bank and commercial banks. Sectoral banks were transformed into classical commercial banks. Simultaneously, the existing 59 branches of the BNB were transformed into autonomous banks. As a result, in early 1991, the banking system was comprised of the BNB, DSK, and 69 commercial banks organized

[384] The BNB was established in 1897. The first governor of the BNB was an official at the Ministry of Finance in Russia. Initially the BNB was not allowed to issue the currency. The BNB was not able to adhere strictly to the gold standard due to the lack of sufficient gold reserves as well as the episodes of inflationary financing of the first and second world wars. The Banking Law of 1947 introduced state monopoly over banking activities. For the history of the BNB, see Avramov (1999).

[385] In 1981, Bulgarian government established Mineralbank to provide credits to newly created small and medium enterprises. Many of those enterprises were part of a web established by the government to trade with the West: they were selling raw materials and energy bought at subsidized CMEA prices on the international market. The profits from price differentials were used to buy goods that Western governments had embargoed against the communist bloc (Stanchev 2001). These enterprises were also heavily borrowing from foreign private banks, and thus contributed to the rising government foreign debt in the 1980s (Barnes 2007: 76-77).

as joint stock companies (Caporale et al. 2002: 224). However, the initial reforms of the banking sector took place in the absence of laws and regulations because the Law on Banks and Credit Activity that established a regulatory framework for bank activities was adopted only in 1992.

At the beginning of 1992, the Bank Consolidation Company, administered by the BNB and the Ministry of Finance, was established with the mission to consolidate, restructure, and privatize undercapitalized SOBs. Three bank consolidation waves were conducted between 1992 and 1995, reducing the number of SOBs from about seventy to around ten by the mid-1990s (Barnes 2007: 82). The largest SOBs created during this process were the United Bulgarian Bank (UBB), Expressbank, and Hebrosbank.[386] After completing the consolidation process, there were 35 banks in Bulgaria; however, the banking sector remained dominated by SOBs (Berlemann, Hristov, and Nenovsky 2002: 22).

Not a single government bank was privatized during the 1991–1995 period (Miller and Petranov 2001: 13). SOBs did not act like traditional banks but rather as government offices used to distribute political loans to loss-making state-owned enterprises.[387] Ministers and their deputies were on the boards of SOBs, so they were able to push for their preferred policies through SOBs.[388] Because SOBs served as "cash cows," both the government and state-owned enterprises were against bank

[386] In the first wave in 1992, Doverie Commercial Bank, Stoibank, and twenty smaller banks merged to create UBB. The second wave of consolidation took place in 1993, during which twelve SOBs were united in Ekspressbank and eight banks merged into Hebrosbank (Barnes 2007: 82). In 1995, Biochim Commercial Bank took over Sofiabank.

[387] Author's interview with Roumen Avramov, former Member of the Managing Board of the BNB (1997–2002) and Economic Advisor to the President of the Republic of Bulgaria (1990–1991), June 24, 2007, Sofia.

[388] Author's interview with Emil Harsev, former Deputy Governor of the BNB, July 2, 2007, Sofia.

privatization.[389] As Kalin Hristov recalls, "The Bulgarian governments on the left and right held the view that the banks were the jewels of the economy. They did not want to sell banks for nickels… But banks have proven to be rather fake jewels."[390]

Officially, financial reform measures were intended to spur competition and decentralization but instead they led to illegal and hidden privatization of banks (unregulated and illegal transfer of capital from state to private hands), particularly during Berov's UDF administration (1992–1994) (Peev 2002).[391] Although no legislative procedure existed for selling off the shares of banks, some banks increased their capital by issuing new shares and selling them immediately to private individuals who were closely related to the insiders' networks. Meanwhile, the BNB and DSK provided the financial resources for these capital expansions (Dobrinsky 1994: 334). Many private banks were created by individuals who wanted to use bank funds to finance their personal business activities. In many instances, the financial resources needed to establish such private banks were borrowed from SOBs. While large loans to bank managers and owners were restricted by law, the regulation was not enforced (Miller and Petranov 2001: 15). The owners of newly created private banks like Credit Bank, Kristalbank, First Private Bank, and Mollov Bank used the regulatory vacuum to "decapitalize" SOBs and transfer capital to their banks (Peev 2002: 24).[392] Anyone

[389] Author's interview with Lubomir Christov, former Chief Economist and Member of the Managing Board of the BNB (1991–1994), June 29, 2007, Sofia.

[390] Author's interview with Kalin Hristov, Advisor to the Governor of the BNB, June 21 and 27, 2007, Sofia.

[391] Lyuben Berov, Economic Advisor to President Zhelev was nominated to lead another nonpartisan government after the collapse of the Dimitrov's administration, for neither UDF nor BSP was able to form a government. The government led by Dimitrov did not have a cohesive focus and was not able to make any important decision without the support of all three parliamentary blocks that supported him. A scandal involving arms exports to Yugoslavia led to a vote of confidence in October 1992, which Dimitrov's cabinet did not pass.

[392] The infamous businessman Valentin Mollow used money from the government owned DSK to create his own First Private Bank, and then took a loan from this new bank to establish another private bank, Mollow Commercial Bank (Barness 2007: 78-82).

with political connections could establish a bank. By the end of 1992, there were 56 banks in Bulgaria, many with low capitalization levels. At first sight, the expansion of the number of private banks resembled improved competition. In reality, a liberal licensing regime, low capital requirements, and weak regulation led to the proliferation of new private banks with political connections.[393] Both SOBs and new private banks were dependent on personal relations with the BNB and the government.[394]

In addition to banks, powerful financial-industrial conglomerates, such as Multigrup, Orion, Olimp, Tron, and Euronergy, emerged. In 1993, the most influential economic groups created Group-13 with explicit political objectives to influence the economic policy of the government to obtain regulatory protection from foreign competition, allowing them to establish a monopolistic position in energy, transport, military industry, and chemicals (Peev 2002: 116). The most powerful member of Group-13 was Multigroup, which in 1994 had over 3,500 employees in at least fifty enterprises including a bank, insurance company, the country's most active stock exchange, and a sugar plant (Barnes 2007: 78).[395] These financial-industrial groups benefited from extensive political connections and banking sector liberalization in order to take over banks, flout supervision laws, and siphon the assets from the most profitable state enterprises into private hands, mainly during the Berov administration

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[393] The capital requirement for licensing a commercial bank was 500 thousand U.S. dollars and there were no regulatory prerequisites concerning the origins of the funds (Vincelette 2001).

[394] Author's interview with Lubomir Christov, former Chief Economist and Member of the Managing Board of the BNB (1991–1994), June 29, 2007, Sofia.

[395] Also, author's interview with Ivan Mihalev, Financial Journalist, Capital Weekly, June 25, 2007, Sofia. For a detailed empirical analysis of Multigroup, see Ganev (2001). Multigroup's leader, former wrestler Ilja Pavlov became the richest man in Bulgaria.

(Koford 2000: 326, Stone 2002: 214).[396] The groups engaged in a so-called "economy of transfer."[397] Consequently, most productive enterprise assets passed into private hands, and the state was left with the debt-ridden, failing ones. Moreover, the government often continued to subsidize these rent-seeking private enterprises.

Incumbent banks, both SOBs and private, were able to exploit loopholes in the law for profit making opportunities. Although the BNB had issued prudential regulations in a number of areas including bank licensing, bank liquidity, and capital adequacy, it failed to enforce these regulations strictly (Christov 1997: 133). Banks were lobbying BNB and the government for national protection from foreign competition, arguing that they needed time to become viable in order to survive harsh international competition.[398] The Bulgarian authorities were responsive to the banks' demands, so they prohibited foreign banks from entering the market right from the outset of the financial reforms. This restriction policy on foreign bank entry was pursued until 1995.[399]

In this weak institutional environment, political insiders, the so-called "credit millionaires," including government banks and enterprises, crony private banks and

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[396] The patron of Multigroup, Andrei Lukanov served in the foreign trade establishment during the Zhivkov era, and then became Prime Minister in the early 1990s. Later, the group developed ties with the Berov government, which was nicknamed the "Multigroup government." Group Olimp also benefited from its ties to UDF, while ORION developed political ties with the Videnov socialist government (Barnes 2007).

[397] Author's interview with Petar Ignatiev, UBB Economist, formerly in the Banking Supervision Department of the BNB, June 25, 2007, Sofia; author's interview with Ivan Mihalev, Financial Journalist, Capital Weekly, June 25, 2007, Sofia.

[398] Author's interview with Martin Zaimov, former Deputy Governor of the BNB and Chairman of the Currency Board (1997–2000), June 28, 2007, Sofia.

[399] In 1994, five years after the start of banking reform, only two branches of foreign banks started operations in Bulgaria, Greek Xios and Dutch ING Bank. In 1995, two additional foreign banks, BNP-Dresdner Bank and Ionian Bank opened branches in Bulgaria. After the government rescinded its ban on branches of foreign banks, several Bulgarian and Russian institutions created the Bulgarian-Russian Investment Bank (with 50–50 Bulgarian and Russian ownership) that later changed its name to Bulbank (Koford and Tschoegl 2003: 18).

enterprises, financial-industrial groups, and individuals belonging to the communist-capitalist web, benefited from extended political connections with political parties and the government to quickly enrich themselves on the account of the population (Peev 2002: 17).[400]

Newly emerging private banks, replicating the behavior of SOBs, were not supporters of monetary and financial stability. Instead, they acted like the *Ponzi* schemes.[401] Both types of incumbent banks were inflationary forces in the Bulgarian economy. They profited from the inflationary environment by paying negative interest rates on deposits and earning positive interest rates on credits.[402] Given high inflation, real deposit rates were highly negative throughout 1991–1993 and deposits were rising rapidly, resulting in an outflow of real income from depositors to banks (Dobrinsky 1994: 50).

In contrast with the Czech Republic, the government and the managers of incumbent banks followed an "explicit" contract based on direct political instructions. In one instance, in spring 1995, the Minister of Finance said that state-owned enterprises should not bother with paying debt to banks but instead they should concentrate on the production.[403] Incumbent banks took active part in this process by providing loans to enterprises, which did not have intention to repay their debt, making these loans implicit subsidies. Banks also engaged in reckless lending to their cronies. As a result, the level of bad loans soared: "[u]ntil 1996, commercial credit

[400] A "credit millionaire" is an individual or an enterprise that has made money by failing to service bank loans (Vincelette 2001: 26).

[401] Author's interview with Kalin Hristov, Advisor to the Governor of the BNB, June 21 and 27, 2007, Sofia.

[402] Author's interview with Nikolay Nenovsky, Member of the Governing Council of the BNB, June 26, 2007, Sofia.

[403] Author's interview with Georgy Ganev, Program Director for Economic Research, Center for Liberal Studies, June 29, 2007, Sofia.

was expanded to the nonfinancial sector in Bulgaria to a degree that was unprecedented relative to any other European transition economy" (OECD 1999: 32). More than 74 percent of total bank loans were nonperforming by 1995 (Miller and Petranov 2001: 13). While high inflation was wiping out some of the banks' bad loans, many of these loans were denominated in foreign currency, and thus the inflation actually increased the debt burden of enterprises (Caporale 2002: 231).

The banks, overburdened with bad loans, were repeatedly refinanced by the BNB on a completely subjective and discretionary basis. The unconditional support for banks by monetary authorities encouraged them to take on even greater risks.[404] The most striking example of bailing out problematic banks was a special program that replaced bad loans for enterprises with government bonds. In December 1993, after heated political debates throughout the year, the Berov government introduced so-called ZUNK bonds, 25-year government debt instruments, which replaced debt contracted before 1991 that had not been serviced for 180 days (Wyzan 1998: 8).[405] These government securities were designed as quasi convertible: banks could have exchanged them for stakes in to-be privatized state-owned enterprises at face value via "debt for equity" swaps and use them as collateral for central bank financing (Dobrinsky 1994: 54 and 2000: 590). In 1996, under the so-called "Bulbank scheme," the Ministry of Finance paid Bulbank (a legal successor of the Bulgarian Foreign Trade Bank) 200 million U.S. dollars for ZUNK bonds with a face value of 400

[404] The first attempt to solve the bad-loans problem was in 1987 when the government decided to reschedule, until 1990, overdue investment credits of industrial enterprises accumulated since 1986. The same approach was applied to agricultural producers, but their credits were rescheduled until the end of 1992 (Caporale 2002: 232).

[405] Various other forms of bank refinancing involving domestic and foreign currency were used including discount refinancing with private securities as collateral, Lombard refinancing with government securities as collateral, and unsecured refinancing (deposit facilities and later arrears) (Berlemann and Nenovsky 2003: 10).

million U.S. dollars. These bonds were then distributed as capital contributions to the banks (Jotev 1998: 3).

Not only the central bank but also DSK, the bank with the biggest household deposit base, directed by both BNB and the Ministry of Finance, was also active in refinancing other banks on the interbank market. The DSK Bank was also one of the principal buyers of government securities, so it was actually functioning like the central bank (Berlemann and Nenovsky 2003: 10). The series of unconditional bailouts of state-owned enterprises and banks during the period 1991–1996 created a vicious circle. While the problem with bad loans persisted because new bad credits continued to emerge, increasing amounts of public money were required to be wastefully distributed in the system (Dobrinsky 2000: 588).

The Bulgarian National Bank: Lender of First Resort

At the center of the Bulgarian clientelistic system of finance was the BNB and Vulchev, its governor. While the 1991 Law on the BNB granted the central bank substantial de jure independence, in practice it was subordinate to the government's political guidance and captured by financial and industrial interests.[406] The government was systematically trying to influence the BNB's interest rate policy, requesting BNB to adjust credit ceilings upwards to individual banks and to provide credits to specific sectors (Christov 1997: 147).

[406] The BNB scored higher on the Cukierman, Webb, and Nyapti (1992) index of legal independence than some industrial countries, like Belgium in 1980-1989. However, its actual independence was below the median (Christov 1997: 140). Ganev joked that the appropriate measure of de facto central bank independence in Bulgaria should be the number of calls from politicians to the BNB that get answered. Author's interview with Georgy Ganev, Program Director for Economic research, Center for Liberal Strategies, June 29, 2007, Sofia. Others claimed that the BNB was granted only "a conditional independence" from the government. Author's interview with Boris Petrov, Head of Analysis Division Treasury of the BNB, June 28, 2007, Sofia.

An even more constraining effect on central bank independence was the Law of Budget, superseding the Law on the BNB in the hierarchy of laws that required the central bank to print money for unsecured credit to finance up to 50 percent of the approved budget deficit for the current year (Nenovsky and Rizopoulos 2003: 920, Christov 1997: 143). The government also regularly rolled over limited advances, which had to be paid off before the end of the fiscal year. So, while in 1992, 94 percent of the budget deficit was monetized, the direct BNB lending covered already 121 percent of central government borrowing in 1994 (Christov 1997: 143–4). The Ministry of Finance regularly took budget financing from the BNB via different channels including direct loans, sales of government securities to the central bank, and sales of government securities to commercial banks.[407] This high level of monetization reflected lack of fiscal discipline and redistribution of state resources through the banks (Ganev et al. 2001: 26).

The people in charge of the BNB's banking supervision department were closely connected to the management circles of major state enterprises and banks (Wyzan 1998: 31), and the outcome of this capture of the central bank was lax banking supervision and discretionary refinancing to commercial banks. The BNB acted as the "lender of first resort" rather than a lender of last resort (Berlemann, Hristov, and Nenovsky 2002: 24). When the government faced resistance to its demands to finance political banks, it simply changed BNB's management. A prominent example of this approach was when Emil Harsev, the Deputy Governor in charge of banking sector regulations and lending to banks was removed by a vote of Parliament in July 1993. This act clearly violated the provision of the central bank law

[407] Due to its role in refinancing banks, some called the BNB the "Ministry of Banking." Interestingly, the BNB was not subordinate to the Ministry of Finance but directly to the Prime Minister. Author's interview with Petar Ignatiev, UBB Economist, formerly in the Banking Supervision Department of the BNB, June 25, 2007, Sofia.

regulating office terms for its governor and deputy governors. There were also a number of internal conflicts between Vulchev, the BNB Governor, who enjoyed close political links with the government, and the rest of the Governing Board over bank reform delays and central bank financing of the government and domestic private banks (Christov 1997: 146).

At times the BNB tried to resist government attempts to infringe on its independence. For example, when the Ministry of Finance stopped paying interest on government debt to the BNB in mid-1992, the central bank reacted by imposing a temporary halt on extending advances and transfers of funds to the Ministry of Finance. This action provoked an intense conflict between these two institutions. Nonetheless, the dispute was eventually settled to the detriment of central bank independence. In other instances of conflict, though, the BNB prevailed. In order to limit the *ad hoc* requirements of the Parliament and the government to lend to individual banks, the BNB started to require government guarantees for these loans, which have proven to be a quite successful strategy (Christov 1997).

The main goal of the central bank, legislatively defined in the 1991 Law on the BNB (Article 2) was "to take actions to maintain the internal and external stability of the national monetary unit." While monetary austerity was the essence of the declared stabilization policy, the de facto monetary policy of the central bank was rather accommodating, and thus compromised economic stabilization (Dobrinsky 2000: 586). As Christov (1997: 40) claims, "Price and exchange rate stability [were] among the bank's objectives, but not first priority… Concerns over liquidity problems of some large banks, however, have too often taken precedence in monetary policy decisions."

Expansive political lending led to a rapidly growing money supply. The entire pre-1997 environment was pro-inflationary. The Bulgarian authorities did not allow

foreign investors into the banking sector, which could have disciplined inflationary behavior of the government and its cronies. In contrast with the Estonian central bank, the BNB did not have the power to liquidate banks when they became insolvent. It was difficult for the BNB to force bank closures because the banks appealed the decisions in courts (Caporale et al. 2002: 228). Gradually, the BNB was losing control over the reserve and money supply sources.

In exchange rate policy, the BNB initially tried to maintain a policy of nominal exchange rate stability by pursuing a high interest rate monetary policy. But it was habitually attempting to pursue two mutually exclusive goals. The central bank often acted as a "firefighter."[408] On the one hand it tried to maintain stability for domestic currency but on the other, it provided bailouts to banks with liquidity problems, which put pressure on the exchange rate because the refinancing of banks added to the demand for foreign exchange. As a result, the BNB's interventions in international financial markets were inconsistent: at times it intervened in an often futile attempt to prevent the lev's decline, but at other times it intervened in the opposite direction, presumably to build up foreign reserves (Dobrinsky 2000: 596).

The foreign exchange market was characterized by strong fluctuations. While Bulgaria adopted a full float initially, in 1992–1993 the BNB pursued a managed float and kept it until 1994. In 1995–1996, the regime approached a full float again due to a substantial loss of foreign exchange reserves. The government forced the BNB to prevent the appreciation of the exchange rate and to keep it at the 18–28 lev per one U.S. dollar level to facilitate the development of state-owned enterprises.[409] Roumen

[408] Author's interview with Lubomir Christov, former Chief Economist and Member of the Managing Board of the BNB (1991–1994), June 29, 2007, Sofia.

[409] Author's interview with Tsvetan Manchev, Deputy Governor of the BNB, June 26 and July 2, 2007, Sofia.

Gechev, the Minister of Economic Development, often complained that the exchange rate depreciated slowly.[410] In 1993, the BNB reduced the basic interest rate twice, responding to government pressure that anticipated a high budget deficit at the end of the year and that wanted to inflate it away. The interest rate reductions triggered a flight from the lev and the nominal exchange depreciated by about 50 percent against the U.S. dollar in March 1994.[411] The resulting exchange rate helped boost exports and contributed to a positive trade balance value of 121 billion U.S. dollars for the first time in fifteen years (Minassian 1998: 332–334). Still, this depreciation was gradually absorbed by rising inflation, which by the end of 1994 exceeded 120 percent (Balyozov 1999: 8).

The BNB (and some of its senior managers) coalesced with the government, state-owned enterprises, and banks in speculative operations related to exchange rate movements. According to Hristina Vucheva, former Minister of Economy and Finance (quoted in Nenovsky and Rizopoulos 2003: 935, fn. 44), in 1994 "every weekend there was an attack on the cash market, an agreement was reached among several banks and the exchange rate was changed in the direction of lev devaluation to ensure safe profits for the players. Then the BNB intervened, buying expensive dollars and so on and so forth till the next hit."

In fact, it is argued that the 1994 sharp lev depreciation was pushed by powerful financial and industrial lobbies like Multigroup.[412] When the government provided banks with liquidity, it usually invested these funds in foreign currencies to

[410] Author's interview with George Chobanov, Vice-Dean and Professor of Economics, Faculty of Economics and Business, St. Kliment Ohridski University, June 27, 2007, Sofia.

[411] The lev fell from 32.71 of the U.S. dollar at the end of 1993 to 55.59 at the end of May 1994, with the sharpest declines in January and March 1994 (Wyzan 1998: 21).

[412] Author's interview with Georgy Ganev, Program Director for Economic Research, Center for Liberal Studies, June 29, 2007, Sofia.

profit from currency speculations.[413] Banks generated large profits from large exchange rate fluctuations and currency depreciation. Banks also took excessive risks in maintaining large credit exposures in foreign currencies that were not subject to any regulation (Dobrinsky 2000: 585). Georgy Ganev aptly describes the rent-seeking behavior of incumbent banks during the pre-1996 period[414]:

> Banks were opportunistic, risk-taking, and speculating at the expense of tax payers. They were issuing bad debts to themselves and engaged in currency speculations, taking long positions and converting domestic assets into foreign currency…floating also enabled the banks to earn rents from exchange rate manipulations… There was a huge moral hazard problem in the banking sector.

The 1996–1997 Banking and Currency Crisis

The popularity of Berov's government decreased in March 1994 when the lev crashed. The BSP won a solid majority in the elections of December 1994 and a new generation of socialist politicians, with Zhan Videnov as Prime Minister, came into power (Koford 2000: 327). The political influence and rent-seeking of banks worsened further under the Videnov government. The policy of soft budget constraints gave rise to reckless credit policies and the snowballing of a new wave of bad loans. As a result, at the end of June 1994, 35 out of 44 Bulgarian banks began to experience financial difficulties (Vutcheva quoted in Berlemann and Nenovsky 2003: 12). Depositors, fearing that their foreign deposits would be confiscated by the government in order to meet its interest payments on the external debt due in July 1996, started to withdraw

[413] Author's interview with Kalin Hristov, Advisor to Governor of the BNB, June 21 and 27, 2007, Sofia.

[414] Author's interview with Georgy Ganev, Program Director for Economic Research, Center for Liberal Studies, June 29, 2007, Sofia.

their deposits en masse.[415] The first wave of the crisis came from the banking system when in May 1996, BNB put five commercial banks, three of which were private, under conservatorship (Table 6.5).[416] The deposits from the bankrupt banks were transferred to the healthy banks.

The general panic among the depositors was further reinforced by the lack of agreement between the Socialist government and the IMF at that time.[417] In order to stop the panic among the population, two strategies were implemented in parallel. First, the Bank Deposit Guarantee Act was passed in the Parliament, guaranteeing the repayment of individual deposits in full and fifty percent of enterprise deposits. Second, after a long period of debt monetization, the BNB started to pursue a restrictive policy towards banks by increasing minimum reserve requirements, raising interest rates, and intervening on foreign exchange markets to prevent the lev devaluation. The BNB raised the base interest rate up to 300 percent in September 1996 (from 108 percent in May 1996), but then it eased monetary policy during the following two hyperinflationary quarters to reduce domestic public debt (to 240 percent in October and then to 180 percent) (Ganev et al. 2001: 30, Berlemann,

[415] The confidence of the public in the banking sector was a key factor in the relative stability of the financial system until 1995. Due to the absence of investment options, most of the savings of the population was channeled to banks, providing the basis for the financing budget deficit and activities of banks (Dobrinsky 2000: 590).

[416] Conservatorship is a legal procedure allowing the BNB to suspend the operation of a bank close to insolvency. In that case, the BNB appoints a conservator who (temporarily) manages the bank (Berlemann and Nenovsky 2003: 13, fn. 17). In May 1996, the BNB put the following banks under conservatorship: Private Agricultural and Investment Bank, Mineralbank, First Private Bank, and Agrobusinessbank.

[417] The previous stand-by arrangement, covering a 12-month period, was approved in April 1994. Nonetheless, owing to slippages of the Bulgarian authorities in monetary policy and delays in structural reforms, it expired at the end of March 1995.

Hristov, Nenovsky 2002: 29). The policy of increasing interest rates, recommended by the IMF, however, further intensified the crisis.[418]

Table 6.5: The Chronology of the Financial Crisis in Bulgaria, 1996–1997

	Dates	Major Events
1995	4th quarter	Early warning signs: Foreign currency reserves begin to fall (after rising in 1994) First bank runs occur. BNB refinances banks as lender of last resort.
1996	1st quarter	Foreign currency reserves fall sharply.
	2nd quarter	Foreign currency reserves reach such a low level than BNB no longer intervenes in the foreign currency markets. Basic interest rate rises in several steps from 34% to 108% (annual rate). Lev depreciates by 100%. BNB lending to banks and the government accelerates.
	3rd quarter	In September the following program is implemented: Conservators appointed for 9 banks (brining the total to 15 or about 1/3 of banks). Basic interest rate is raised to 25% per month. More support given to the viable banks.
	4th quarter	Basic interest rate lowered to 15% per month to help banks. November: IMF recommends the establishment of a currency board. December: There are street demonstrations in Sofia and the government resigns.
1997	1st quarter	Early February: Political crisis is finally resolved and an interim government is appointed and dates for new elections are announced. Negotiations between the IMF and the new interim government begin almost immediately.
	2nd quarter	April: Agreement is reached with IMF on new standby package. April: United Democratic Forces wins majority in parliamentary elections.
	3rd quarter	July 1: Currency Board established.

Source: Beck, Miller and Saad (2003: 7).

[418] Former BNB Deputy Governor Harsev harshly criticized the IMF policy of high interest rates. For him, interest rate increases did not work because economic actors anticipated inflation. This produced inflation expectations because enterprises calculated higher inflation in the prices of their products. Author's interview with Emil Harsev, former Deputy Governor of the BNB, July 2, 2007, Sofia.

High interest rates caused bankruptcy of another nine banks and a sharp increase of government internal debt.[419] The BNB reacted by changing the minimum reserve requirements in the opposite direction: it lowered them from 9.5 percent to 8.5 percent but then raised them again to 11 percent in December 1996. Altogether, fourteen banks (out of 46) were closed in 1996 and these represented 24 percent of the banking system's assets.[420] The rent-seeking policies manifested themselves in the fact that ninety percent of uncollateralized refinancing was concentrated in bankrupt banks. The banking crisis was accompanied by increasing currency substitution: the share of foreign exchange in broad money went up from 27 percent in 1995 to 50 percent in 1996 (Ulgenerk and Zlaoui 2000: 7).

In parallel with the BNB's restrictive policy regarding banks, the government and the parliament, fearing the moratorium on internal debt, forced the central bank to provide extensive monetary financing of the unsustainable budget deficit, the outcome of financial rescues of crony banks and enterprises.[421] In a special letter to the Government and the Parliament, the BNB Managing Board expressed its disagreement with this credit line, pointing to its inflationary effects.[422] Nonetheless, at the end of 1996, the BNB ceded and granted to the Ministry of Finance a loan in the amount of 115 billion lev that represented a full 7 percent of GDP (Berlemann and Nenovsky

[419] These included: Commercial and Savings Bank, Balkanbank, Economic Bank, Businessbank, Elitebank, CB Slaviani, CB Mollow, Dobrich CB, and Yambol CB.

[420] The cost of the Bulgarian banking crisis represented 75 percent of GDP (Tang, Zoli, Klytchnikova 2000). For a detailed examination of the Bulgarian banking crisis, see Ignatiev (2005).

[421] In September 1996, in the face of a severe crisis of confidence in government, no economic agent was willing to buy government bonds. Minister of Finance Dimitar Kostov invited primary dealers of banks and "begged" them to buy government securities. This approach was a clear sign that the government was bankrupt. Because banks did not show any interest in buying government securities, the BNB had to participate in the primary market. Author's interview with Lena Roussenova, former Member of the Governing Council of the BNB, June 22, 2007, Sofia.

[422] Author's interview with Lena Rousenova, former Member of the Governing Council of the BNB, June 22, 2007, Sofia.

20002: 14). Thus, the BNB was pursuing a dangerous policy mix of high interest rates towards the banks combined with expansionary financing of the budget. The government completely abolished BNB independence by amending the central bank law that allowed the Parliament to terminate the term of its governor and deputy governors by a 60 percent majority vote without providing specific reasons. Subsequently, the government changed the BNB management and appointed the Prime Minister's advisors as chairmen of supervisory SOB boards to ensure financial support for its industrial policy (Christov 1997: 149). As Vice Governor of the BNB, Tsvetan Manchev recalls, "It was much easier to change the Governor of the central bank than to change the government economic policies."[423]

Table 6.6: Governors of the Bulgarian National Bank, 1989–2004

Governor	*Tenure*	*Background*
Ivan Dragnevski	December 20, 1989–January 9, 1991	Banker (Chairman of the Bulgarian Foreign Trade Bank)
Todor Valchev	January 9, 1991–January 24, 1996	
Lyubomir Filipov	January 24, 1996–June 11, 1997	Central Banker (Member of the BNB Board)
Svetoslav Gavriiski	June 11, 1997–October 9, 2003	Ministry of Finance Official
Ivan Iskrov	October 9 2003	Banker (Deputy Chairman of DSK Bank and Executive Director Rosseximbank) and Member of the Parliament

Source: Bulgarian National Bank.

[423] Author's interview with Tsvetan Manchev, Deputy Governor of the BNB, June 26 and July 2, 2007, Sofia.

While the first impulse came from the banking system,[424] the banking crisis led to a currency crisis that exemplified third generation moral hazard crises (see chapter 2) (Krugman 1998, Chang and Velasco 1998).[425] The BNB initially tried to defend the value of the lev, which came under strong pressure in 1996. Nevertheless, the BNB interventions resulted in a dramatic decrease in its foreign currency reserves. In 1996, the lev depreciated by 590 percent and the exchange rate collapsed in February 1997 when the lev depreciated by almost 250 percent. The devaluation was accompanied by a 45 day-period period of hyperinflation: the monthly inflation was 44 percent in January 1997 and 243 percent in February 1997 and the annual inflation for 1997 was 578 percent (Figure 1). This hyperinflation reduced the government's internal debt and cleaned up the balance sheets of banks,[426] leading some Bulgarian commentators to believe that incumbent banks could have provoked hyperinflation.[427]

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[424] Others argued that the main impetus behind the 1996–1997 financial crisis and subsequent economic collapse lay in psychological reasons related to the "grain crisis" in spring 1996. The socialist government re-established price controls on grain, allowing economic elites with political connections to the government to buy grain at regulated low prices in Bulgarian lev and subsequently sell it at world prices, and thus make huge profits. This led to severe shortages of grain in March 1996, provoking a panic among the population because of the lack of the essential commodity, bread. It also meant the beginning of the "bread crisis," leading to a complete loss of political confidence in the government. Once popular support eroded, the government was not able to exercise its power. The 1996–1997 crisis was a combination of bread, banking, currency, political and economic crisis, leading to complete social chaos. Author's interview with Georgy Ganev, Program Director for Economic Research, Center for Liberal Studies, June 29, 2007, Sofia.

[425] In contrast to the 1997–98 Asian financial crises, the Bulgarian crisis was a closed economy crisis. Capital outflows were very small (about 240 million U.S. dollars) because there were no substantial capital inflows (Berlemann and Nenovsky 2003: 17). For excellent examinations of the Bulgarian financial crisis of 1996–1997, see Berlemann and Nenovsky (2003), Balyozov (1999), Dobrinsky (2000), Berleman, Hristov, Nenovsky (2002), Roussenova (2002).

[426] The hyperinflation reduced the government debt from unsustainable levels in 1996, when interest payments represented 18 percent of GDP, to 2.5 percent in 1998 (Avramov 1999: 10-11).

[427] Author's interview with Roumen Avramov, former Member of the Managing Board of the BNB (1997–2002) and Economic Advisor to the President of the Republic of Bulgaria (1990–1991), June 24, 2007, Sofia.

The government engaged in the negotiations with the IMF in May 1996. While the IMF tried to discourage Estonia from instituting a CB, Michael Deppler, Director of the First European Department of the IMF, urged the Bulgarian authorities to adopt a CB in the second half of 1996, when Bulgaria was extended a fourth stand-by agreement.[428] The IMF representatives considered the currency to be the only potent tool to deal with the financial crisis because it promised a framework to discipline both monetary and fiscal policies.[429] Notwithstanding, the IMF warned that a CB needed to be supported by a vigorous commitment and implementation of a bank privatization program. The IMF insisted that the Bulgarian government privatize banks and liquidate those with weak balance sheets. This strategy would allow the government to cut off the rent-seeking banks and enterprises from state and BNB financing.[430] The IMF publicly announced that it would not provide further financing unless the Bulgarian authorities adopted a CB.[431]

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[428] In fact, the IMF first launched the idea of a CB already in 1994 in discussions with the representatives of the BNB. However, the timing was not right due to the upcoming change in the political regime because it was clear that the BSP would win the elections. Thus, these discussions were only exploratory at that time. Author's interview with Roumen Avramov, former Member of the Managing Board of the BNB (1997–2002) and Economic Advisor to the President of the Republic of Bulgaria (1990–1991), June 24, 2007, Sofia.

[429] According to Roussenova, who became a Member of the BNB Governing Board in the middle of the financial crisis and participated in the meetings of Bulgarian authorities with the IMF, the IMF representatives first suggested a money-based stabilization program, which was inappropriate and set unrealistic monetary targets. For her, the IMF designed this program to intensify the crisis to pave the way for the CB. The BNB Governing Council at the end approved the IMF designed program and the IMF extended the first tranche of the loan; however, the second tranche was never extended. A new round of negotiations of a stand-by arrangement was held in Sofia in May 1996. In July 1996, the Bulgarian government requested from the IMF a 20-month stand-by arrangement in the amount of 400 million SDR (86 percent of quota). Author's interview with Lena Roussenova, former Member of the Governing Council of the BNB, June 22, 2007, Sofia.

[430] See EBS/96/116, IMF, A Paper on Bulgaria's Request for a Stand-by Arrangement, July 5, 1996; and EBS/97/53, A Paper on the Request of the Government of Bulgaria for a Stand-By-Arrangement and Request for Purchase under the Compensatory and Contingency Financing Facility, April 3, 1997.

[431] Author's interview with Lena Roussenova, former Member of the Governing Council of the BNB, June 22, 2007, Sofia. Although IMF Managing Director Stanley Fisher was critical of a fixed regime, the successful experience of Estonia gradually convinced the IMF representatives that a fixed regime is an efficient stabilization tool (Stone 2002: 224).

The financial crisis was accompanied by a deep political crisis and 40 days of popular demonstrations, which culminated on January 10, 1997 when the Parliament was attacked.[432] The opposition in the Parliament introduced the initiative called "Declaration of National Salvation" that promised to dismiss the BNB board, launch negotiations with the IMF, introduce a CB, dissolve the parliament and hold early elections (Stone 2002).[433]

Initially, Bulgarian politicians on all sides of the political spectrum resisted the introduction of the CB, mostly on the sovereignty grounds.[434] A political stalemate between the government and the opposition delayed the implementation of a currency-board-based program (Pautola and Backé 1998: 89). Similarly, the BNB Governing Council wrote a letter to the prime minister expressing its opposition to a CB.[435] But the IMF insisted on achieving national consent before adopting a CB (Simeonova 2007: 119). Nonetheless, when the crisis escalated further, the Socialist government decided to give up sovereignty and to adopt a CB, for it became an unavoidable option to end the economic crisis. In the final states, the crisis brought down the Videnov government and destroyed the BSP's electoral base. A new President, Petur Stoyanov, took office and appointed a caretaker government with Sofia's Mayor Stefan

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[432] The idea of mass protests started to develop already in the summer of 1996 as the initiative of the major trade unions: Podkrepa and the Confederation of Independent Trade Unions in Bulgaria (Simeonova 2007: 123).

[433] The Bulgarian CB, including the strategy of banking privatization and fiscal reforms, was designed by the IMF. Charles Enoch, Deputy Director of the IMF Monetary and Financial Systems Department designed most parts of the CB Law, as well as the law on banking supervision. Author's interview with Tsvetan Manchev, Deputy Governor of the BNB, June 26 and July 2, 2007, Sofia.

[434] Author's interview with Martin Zaimov, former Deputy Governor of the BNB and Chairman of the Currency Board (1997–2000), June 28, 2007, Sofia.

[435] Author's interview with Roumen Avramov, former Member of the Managing Board of the BNB (1997–2002) and Economic Advisor to the President of the Republic of Bulgaria (1990–1991), June 24, 2007, Sofia.

Sofiyanski (UDF) as a caretaker Prime Minister. In the declaration of February 2007, a comprehensive reform package with the CB at its heart was embraced by all major political parties.[436]

The Currency Board and Banking Reforms After 1997

New parliamentary elections were held in April 1997, when the UDF won an overwhelming victory.[437] The new UDF government of Ivan Kostov, an economist who had served as minister of finance in the short-lived UDF government, officially adopted a CB, modeled on the Estonian example, on July 1, 1997.[438] However, the BNB had already started to function as de facto CB in March 1997. The lev was fixed at the exchange rate 1,000 lev per 1 ***D****eutsche mark*.[439] The CB brought the country's inflation rapidly under control: inflation fell from 2,040 percent per annum in the first quarter of 1997 to 1 percent per annum in 1998 (Lewis 2002: 141).[440]

In addition, the new UDF-led government introduced several institutional changes in central banking accompanied by important changes in the banking system. In June 1997, the Parliament passed a new Law on the BNB making it independent from the Council of Ministers and other state bodies and altering its structure so that it

[436] As in Estonia, many Bulgarian politicians now claim credit for the CB. At some point, all political strings competed to introduce a CB (Berlemann and Nenovsky 2003: 17, fn. 25).

[437] The UDF won 52 percent of the popular vote and 57 percent of the seats. The Socialists and their partners, the Ecoglasnost movement, captured 22 percent of the vote and 24 percent of the seats.

[438] Steven Hanke, who was involved in the establishment of the CB in Estonia, became Advisor to Bulgarian President (Nenovsky and Rizopoulos 2003: 936).

[439] After the lev denomination and the introduction of the euro, the exchange rate was fixed at 1 Euro=1.95583 lev.

[440] On the impact of CB on price dynamics, see Beck, Miller and Saad (2003), Nenovsky and Dimitrova (2002).

was transformed into a CB.[441] Most importantly, the law restricts the possibility of monetizing government fiscal debt. Also, the Parliament passed a new banking law which incorporated a tightening of banking regulation.[442] With the establishment of the CB, banking supervision became an integral part of the new exchange rate strategy, and a separate BNB department was charged with licensing and supervising banks. As a result of a new currency regime, the behavior of the BNB changed almost immediately. When two banks suffered liquidity difficulties after 1997, the BNB (as its Estonian counterpart) did not bail them out and instead let these banks fail.[443] The BNB took this approach in spite of the fact that the Bulgarian "second generation" CB system allowed it to provide a limited lender of last resort facility to stabilize the banking system (Hristov and Nenovsky 2002).[444]

In sum, establishing the CB was driven primarily by the need to end practices that were impeding banking reforms (Wyzan 1998). Bank privatization became a cornerstone for the confidence of the newly established exchange rate regime and necessary to sustain it.[445] The UDF government adopted an approach to bank privatization and supervision similar to the Hungarian strategy from the early years of

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[441] As in the case of Estonia, the Law on BNB established the Issue Department to run the CB and the Banking Department to act as a lender of last resort in case of systemic risk for the stability of the banking system (Nenovsky, Hristov, and Mihaylov 2002: 26).

[442] The minimum level for the capital adequacy ratio was set at 12 percent. In 1998, a Deposit Insurance Fund financed by commercial banks was established. For a detailed analysis of the post-1997 legal framework for bank supervision, see Ignatiev and Simeonov (1999).

[443] At the beginning of 1999, the Credit Bank was declared to be insolvent and in 2000, the Bulgarian Universal Bank went bankrupt.

[444] There are some restrictions on the BNB lender of last resort functions, however. The BNB can use excess reserves and grant credits only to solvent banks experiencing an acute need for liquidity that cannot be provided from other sources. These loans can only be extended against collateral of liquid assets and the loan repayment term should not exceed 3 months (Berlemann and Nenovsky 2003: 20).

[445] Author's interview with Tsvetan Manchev, Deputy Governor of the BNB, June 26 and July 2, 2007, Sofia.

transition. Bank privatization started in 1997 with the sale of UBB to the EBRD (35 percent), US Oppenheimer and Company (29.63 percent), and Bulbank (35 percent). Similarly, PostBank was sold to the American Life Insurance Company and Consolidated Eurofinance Holding (78.23 percent). SOB privatization ended with privatizing DSK in 2003 quite exclusively to foreign investors from Austria, Italy, Greece, and Turkey. [446] In 2004, the share of foreign bank assets represented nearly 82 percent of total banking assets, so Bulgaria imported the lender of last resort function from abroad because the CB forbade the BNB from playing this role.[447] Bank privatization combined with restrictions on central bank lending weakened rent-seeking networks of banks, industries, the BNB, and the government.[448] Bank lending to the public sector significantly decreased, signaling that moral hazard behavior was severely restricted under the CB.

Comparative Assessment and Conclusion

Chapter 6 has examined evidence from two important exchange rate strategies and financial liberalization programs in EE—those of Estonia and Bulgaria—that support the main arguments of this study. Both countries embarked on economic reforms with financial system dominated SOBs and new private banks that were often created as captive funding mechanisms by enterprises or individuals, allowing them to

[446] Simultaneously with bank privatization, the UDF government also conducted cash sales of state-owned enterprises to foreigners and used the revenues to restore the depleted level of exchange rate reserves in 1997. It also implemented management-employee buyout schemes that spurred corruption scandals and brought down several members of Kostov's government, including Deputy Prime Minister Aleksander Bozhkov (nicknamed Mr. Ten Percent) (Miller and Petranov 2000: 230, Barnes 2007: 90-91).

[447] The only remaining SOB is Encouragement Bank created specifically to support small enterprises.

[448] There was an internal scandal concerning the privatization of Bulbank. The government initially promised bank managers 2–3 percent of bank shares to obtain their support for privatization but then it sold all shares to the Italian bank, Unicredito. Author's interview with Georgy Ganev, Program Director for Economic Research, Center for Liberal Studies, June 29, 2007, Sofia.

tap bank resources of bank. These insider banks tried to achieve short-term profits by taking excessive risks, often in the form of high-risk lending to crony enterprises, or by assuming large open foreign exchange positions. High inflation and macroeconomic instability magnified the power and rents of incumbent financiers and industrialists. A fixed exchange rate regime, associated with extreme discipline on monetary and financial regulatory policies, was thus not welcome by these incumbent interest groups. In examining these two cases, it is apparent that government commitment to financial liberalization appears to be a necessary condition for dissipating rents and dismantling distributional coalitions. Notwithstanding, the Estonian and Bulgarian governments had a different capacity to resist the pressures of incumbent financial and industrial interests, protect their central banks from political interference, and commit to a sustainable fixed exchange rate regime and to bank reform programs that brought in new foreign owners.

Estonia established a CB against IMF advice and in spite of insufficient foreign exchange reserves to back it off. The government's commitment to a hard peg and financial liberalization precluded the newly (re)established central bank to credit incumbent banks, which benefited from high inflation and exchange rate speculations prior to the 1992 monetary reform. The CB also imposed a fiscal discipline because the government could not borrow from the central bank. From the outset of the transition, Estonian authorities imposed hard budget constraints on banks and strict fiscal rules. They signaled to banks that they should not count on bail outs because these would undermine the sustainability of a fixed regime, the credibility of which was a cornerstone of government reform policies. The BOE had a monopoly in currency affairs and was able to apply an arms-length relationship with banks and enterprises. The liquidation and privatization of government banks and enterprises coupled with liberal foreign investment and trade regimes created an environment that

favored outsiders. A currency board was also a way to attract foreign investors interested in stable currency and low inflation.

In contrast, the Bulgarian governments were not able to commit to a sustainable stabilization program based on a fixed exchange rate, impose monetary and fiscal discipline on economic players, and commit to bank privatization until the 1996–1997 crisis. Most banks were still government owned at the time of crisis. Government involvement burdened SOB portfolios that were granting loans to enterprises on behalf of the government and their losses were subsequently nationalized. In a generalized atmosphere of soft budget constraints, inflationary credit policies, and weak banking regulation, new private banks replicated the behavior of SOBs. In contrast to the BOE, the BNB was captured by the government and incumbent interest groups gave them effective access to the instruments of monetary policy. The BNB had a problematic three-fold mission. In addition to protecting both the exchange rate and the banks, the BNB was obliged to finance a large part of the budget deficit. The moral hazard behavior induced by explicit governmental guarantees that the government would bail out incumbent banks and industries facing financial problems resulted in the financial crisis in 1996–1997. Only the crisis prompted the government to commit to a CB accompanied by a strict system of bank regulation and supervision and a new law on central banks that granted the BNB independence from the government. Finally, following the Estonian example, Bulgaria also opened its domestic financial market to foreign banks.

In spite of similar economic problems associated with the collapse of communism, two factors increased difficulty for exchange rate and financial policies in Bulgaria in comparison with Estonia. First, Bulgaria started the transition with a large debt burden reflecting the large share of loans denominated in foreign currencies,

which retained their value even in conditions of high inflation.[449] These were loans from foreign banks to the Bulgarian government, which were then recorded internally as foreign currency loans from the BNB to state enterprises (Caporale et al 2002: 231). In March 1990, Bulgaria announced a unilateral moratorium on its foreign debt service. Therefore, the only access of the government to foreign financing was on an official level from international institutions.[450] The country was excluded from international capital markets and was unable to borrow abroad until July 1994, when the foreign debt was restructured in a Brady deal and Bulgaria received some support from financial institutions. In contrast, because Russia removed debts from ex-Soviet republics, Estonia started the transition with a low debt burden (10 percent) (Hansson 1995: 160). Second, socialist banks in both countries extended loans to state-owned enterprises in the pre-transition period, but while hyperinflation wiped out these loans in Estonia, most bad loans in Bulgaria were denominated in foreign currency, and thus were not swept by the initial high inflation and currency devaluation.

The two cases studies discussed in this chapter illustrate other important theoretical arguments. First, the cases show that political instability has less to do with explaining a commitment to a sustainable fixed regime. Both countries have had numerous changes of governments, Prime Ministers, and parliaments but they conducted different financial and exchange rate policies. In Estonia, the CB and financial reforms enjoyed the support of an anticommunist majority in the parliament despite many government transitions (Frye 2002: 317).[451] Admittedly, in polarized

[449] According to the BNB, the external debt of the Bulgarian government was 12.4 billion U.S. dollars in 1992.

[450] Since September 1990, when Bulgaria became a member of the IMF, it signed 13 short-term agreements with the Fund and received 2.2 billion SDRs (Manchev 2007).

[451] Laar (2007: 4) claims that that launching a radical reform program would have not been possible without a stable majority in the parliament. Interestingly, the Pro Patria government had a majority of only *one* vote.

Bulgaria, the fractious parliament and inability to form a majority government until 1995 have influenced the country's incoherent reforms, including the government's unwillingness to commit to a painful stabilization program based on fixed regime, and delayed privatization (Stone 2002, Frye 2002: 316–317).

Second, a theoretical view based on the weight of government partisanship tested in chapter 4 is also a poor predictor of exchange rate policies in these two countries. While there has been considerable continuity in both cases in terms of the communist pedigree of the political elite in the first years of the transition, different from Bulgaria, the strong successor to the Communist Party did not survive in the political space of post-communist Estonia.[452] Moreover, a strong left party in Estonian political life has not developed, either. In spite of quite frequent changes in governments, Estonian politics has been dominated by centrist or center-right parties and conservative-liberal politicians, particularly during the initial phase of independence. Even political parties belonging to the left of the Estonian political spectrum have pro-market oriented economic policies.[453] The distinction between left and right wing policies concerns values rather than economic policies.[454] Bulgaria developed reasonable strong political parties on the left and right, which proposed

[452] The Communist Party's successor, the Estonian Left, only made a brief appearance in parliament following the 1999 elections in a joint candidates' list together with the United People's Party of Estonia. The Center Party led by Savisar provides a leftist party image, appealing to the losers of the transition but the party's intentions are rather populist. Author's interview with Evald Mikkel, Department of Political Science, University of Tartu, July 20, 2007, Tallinn.

[453] The first Prime Minister Tiit Vahi, whose Coalition Party, in alliance with the Agrarian Rural People's Union won again in 1995 admitted that while he favored a German style "social market economy, he supported right-wing policies." See "Estonia: Success punished." *The Economist*, March 11, 1995: 51. A position in the communist regime's power structures did not determine the ideological preferences of the Estonian elite, either. For example, Arnord Ruutel, former Estonian President, was the last President of the Supreme Soviet since 1983, but later became the chairman of the nationalist-conservative Estonian People's Rural party (Steen and Ruus 2002: 232-234).

[454] Author's interview with Karsten Staehr, Faculty of Economics and Business Administration, Tallin University of Technology and Research Supervisor at the BOE, July 16, 2007, Tallinn.

very different economic reforms (Fish and Brooks 2000: 63). Yet, the Bulgarian case shows that it is difficult to sustain the view that before the 1996–97 crisis, the left Party, the BSP, promoted ideas about redistribution, while the right party, the UDF, was willing to adopt a sustainable fixed exchange rate and coherent reform policies, for the business constituencies of the right wing parties were expected to favor exchange rate stability and low inflation. The economic reform choices of the Bulgarian governments dominated by left or right did not correspond to political value systems (Stanchev 2001). Regardless of their political orientation, the governments in Bulgaria were not able to commit to a currency peg; they kept control of the banking industry and used it for its own short-term objectives of supporting the budget and loss-making state enterprises.

Third, instead of political ideology, a different occupation experience and the level of national identity formation may have influenced the decisiveness with which the Estonian government exited the ruble zone and adopted radical reform policies. In one view, the perception of Russia as an "external threat" as well as the large Russophone population acted as a homogenizer of the Estonian elite on the necessity of conducting radical reforms and cutting ties with Soviet interest groups (Frane, Tomšič, and Kristan 2008: 49–51). To this end, the Estonian government was politically motivated to resist the influx of "dirty" Russian capital into the Estonian financial system.[455] As Prime Minister Laar (2002: 165) argued, "National pride, which saw the orientation towards the West almost as a national mission" played an important role in the success of reforms.

[455] Author's interview with Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999–2002), July 19, 2007, Tallinn. One manager of American Bank of the Baltics expressed his view on the licensing policy of the BNB in 1992 in the following way: "If a big Western bank like NatWest were to apply, they wouldn't say no. But they would turn down one of the small, newfangled Russian banks" (Euromoney, June 1993: 164).

In light of national identity perspective, Estonians politically linked the exit from the Russian sphere of influence and introduction of the independent currency to their "shared understanding of the purposes of their statehood," one of them being a "return to Europe" (Abdelal 2001: 47). Nonetheless, it is puzzling why, in spite of the fact that the Estonian public opinion has consistently been one of the most Euroskeptic countries, the government has tied its newly established national currency to the Deutsche mark, while Bulgaria, being among the countries for which the EU has the most positive image, adopted a fixed regime only when dealing with the severe financial crisis became unavoidable.[456] Despite differences in the initial choices of exchange rate regimes observed in Estonia and Bulgaria, their respective governments have pursued CBs in the most recent years (table 6.7).

As Jeffrey Sachs (quoted in Nash 1995) pointed out, "A currency board is a straitjacket on a central bank, an extreme discipline on extremely bad behavior." These cases show that a CB cannot itself create credibility unless accompanied by firm supporting policies, of which liberalization of the banking sector is particularly important. After assessing policy for a sustainable CB, Vahur Kraf, the governor of the BOE proudly claimed, "Today I dare to recall ten years and say—it has been worth it to adhere to firm principles to have an open banking system" (2002: 18).

[456] The public opinion in Estonia has been Eurocentric mainly as a consequence of historical legacies (in particular, the negative experience of being in a "union", the USSR and a glorified view of the country's inter-war independent statehood); special links with the Scandinavian countries with similarly strong anti-EU feelings; and some unpopular government policies linked to EU accession. Public opinion has strongly influenced party orientations (Mikkel and Pridham 2004: 725).

Table 6.7: The Main Characteristics of the Currency Boards in Bulgaria and Estonia

	Bulgaria	Estonia
Established	July 1997	June 1992
Previous exchange rate regime	Floating	Ruble standard
Access to convertibility at the monetary authorities	General public and banks	In principle, general public, in practice, only banks
Coverage of backing	100 percent of monetary base and government fiscal reserves	100 percent of monetary base
Power to change the exchange rate rule and backing rule	Devaluation needs to be done by an act of the parliament	The BOE has the right to revalue the exchange rate. Devaluation needs to be done by an act of Parliament
Lender of last resort	By the BNB, restricted to systemic and emergency situations; limited to the amount of foreign exchange in excess of backing requirement, that is, reserves of the Banking Department	By the BOE; restricted to systemic and emergency situations; limited to the amount of foreign exchange in excess of backing requirement, that is, reserves of the Banking Department
Reserve requirements	Yes	Yes
Treasury bills	No	No
Central bank bills	No	Yes; BOE CD's were initially issued in may 1993 with a view to increasing collateral that banks can use in interbank market
Credit to government by the monetary authorities	Prohibited	Prohibited
Political commitment	Moderate (political unanimity with desultory voices for currency board abandonment)	Strong (full political unanimity)

Source: Adapted from Nenovsky, Hristov, and Mihaylov (2002: 12–13).

The CB has enjoyed a strong public support and has been perceived as a pillar of a successful monetary and exchange rate policy in both countries. While there have been occasional complaints and discussions about possible changes of a hard peg that

are motivated by high real appreciation of their national currencies, no economic actor or a politician did seriously question CB policies.[457] CB has been a success story in both countries because it has brought currency credibility and stability. Both countries foresee joining the EMU without altering the current principles of monetary and exchange rate policies.

[457] Most of my interviewees in both countries argued that in spite of real exchange rate appreciation, high productivity and considerable export growth are proof of increased national competitiveness.

CHAPTER 7

THE CZECH REPUBLIC: COLLUSION

Klaus seemed to have remembered Lenin's dictum about banks being the "commanding heights" of the economy; he was reluctant to let these institutions go and risk their coming under the control of foreign financiers.

Stroehlein[458]

Similar to the cases of Estonia and Bulgaria, the history of exchange rate politics in the Czech Republic helps us to evaluate the importance of financial institutional structures in our search to explain the choices and sustainability of the exchange rate regime. There is one identifiable turning point in the Czech exchange rate history: 1997. The Czech Republic, as part of the former Czechoslovakia, started the post-communist transformation with a "big bang" stabilization program based on a fixed exchange rate as a nominal anchor. In May 1997, financial turmoil forced the central bank to abandon a fixed regime that had persisted for 62 consecutive months, surviving the split of Czechoslovakia and the dissolution of its common currency. The central bank let the Czech koruna float and introduced a new monetary policy strategy: inflation targeting.

The case of the Czech Republic demonstrates how a clientelistic financial system, dominated by incumbent banks and industries, leads to financial instability and forces the government to drop formal promises to maintain a fixed exchange rate regime. The financial system in the Czech Republic in the 1990s, which has emerged as the outcome of voucher privatization of banks and industries, was characterized by "collusion" among domestic banks, industries, and the state. Nonetheless, in contrast

[458] Stroehlein (1999: 13).

to the clientelistic financial system in Bulgaria, the independence of the Czech central bank became a distinguishing feature of Czech economic policy-making.

The voucher privatization of banks and industries resulted in the indirect control of privatized enterprises by banks, through their investment privatization funds (IPFs), which were in turn controlled by the government. By establishing IPFs, banks became not only creditors but also owners of enterprises. The incumbent banks often acted as extended hands of the government and provided credits based more on political expediency rather than on prudent credit risk policies. Banks as owners of industrial holdings were also motivated to bail these enterprises out when they were in financial difficulties. While the Czech government imposed fiscal discipline, it was unwilling to impose hard budget constraints on domestic banks. Both the Czech and Estonian governments were committed liberalizing governments, undertaking sweeping trade and capital account liberalization. However, unlike those in Estonia, the Czech financial markets were exposed only to a limited degree of financial openness as the Czech government resisted the acquisitive advances of foreign banks. The outcome of the Czech financial reforms was expansive politicized lending, weak banking regulation and supervision, high volumes of bad loans, repeated bank bailouts, and banking sector instability, all of which led to financial turmoil and forced changes in the fixed exchange rate regime.

Unlike the other three countries examined in this study, the Czech Republic started the post-communist transition with advantageous historical legacies. The Czechoslovak communist governments were fiscally conservative at the outset of transition, so the country enjoyed low domestic government indebtedness, small external debt, virtually non-existent inflation, and no shortages or parallel markets.[459]

[459] The total government debt did not exceed 1 percent of the GDP and the annual rate of inflation was stable at around 1-2 percent per year (with hidden inflation, this rate was 5 percent). Foreign debt was low at around 8 billion U.S. dollars. See Soukup, Taci and Matoušek (2004), Drábek (1995), Erbenova

Along with the former East Germany, Czechoslovakia had been the most industrially advanced country in the Soviet bloc.[460] The latter was also the only EE country that experienced continuous democratic capitalism during the inter-war period.[461]

Thus, a radical stabilization program was less of a necessity in the former state of Czechoslovakia, for its macro-economic fundamentals were good. Still, the first post-communist governments had each inherited a state with a strong position vis-à-vis poorly organized social and political groups, and a considerable mandate to pursue economic reforms, including a fixed exchange rate regime and mass privatization through vouchers. The Czech state was a very strong post-communist state, both as a result of its post-1968 totalitarian dictatorship and its quick government consolidation after 1989 (Orenstein and Desai 1997: 44).

On the other hand, some initial conditions complicated the transition in the beginning. Much like in Estonia and Bulgaria, Czechoslovak trade was heavily concentrated on CMEA countries, reaching nearly 80 percent of trade and 60 percent of Czech exports in the late 1980s. Therefore, the collapse of the CMEA market produced serious disruptions to trade, capital flows, and domestic production.[462] The proximity of Czechoslovakia to the German and Austrian markets, however, soon provided new markets for exporters after the collapse of CMEA.

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and Holub (2006). See Korbel (1977) for the modern history of Czechoslovakia from its creation in 1918.

[460] Before World War II, Czechoslovakia was a democracy, with an average GDP per capita comparable to that of Austria. In 1938, the GDP per capita in Austria was 400 U.S. dollars, while in Czechoslovakia it was 380 U.S. dollars (Dyba and Švejnar 1995: 22).

[461] Czechoslovakia had four free elections during the First Republic (1920, 1925, 1929, and 1935) and a semi-free election in 1946.

[462] Total loss of output due to the collapse of CMEA was estimated to be around 30-50 percent in 1991–92 (Drábek 1995: 244, Dyba and Švejnar 1995).

In contrast to Poland, the Czechoslovak state appeared to be very much in control of the economy in the late 1980s. The economy was dominated by large-scale heavy industry and monopolistic trade organizations. Although the Czechoslovak communist leadership loosened regulations on joint ventures in 1988, it did not fully legalize private enterprises until 1990 (Barnes 2003: 551). As a result, 93 percent of the gross national product in 1988 was still being produced in the state sector, while private sectors employed only about 1.2 percent of the labor force (Schwartz 2006: 34, Kočenda 1999: 6–7).

Klaus and the Origins of Czech Capitalism: Thacherism, Czech Style or National Capitalism?

After the communist party was brought down by pressure from street demonstrations in November 1989, the transitional government, a "Government of National Understanding," composed of reform communists, social democrats from 1968, and dissident leaders took power in on December 10, 1989 to plan economic reforms and prepare for free elections in June 1990.[463] Václav Havel, a famous dissident playwright and the leader of Civic Forum, the mass organization formed by a group of prominent dissidents from Charter 77 in 1989, became president.

Following the 1989 "velvet revolution," there was broad agreement in the former Czechoslovakia on the need to build a market economy but a great controversy about the economic reform strategy. The discussion was between two ideologically conflicting views on the transformation strategy among a group of economists at the Institute for Economic Forecasting at the Czechoslovak Academy of Sciences, who were invited to join the Civic Forum to design a program of economic transition. The

[463] The collapse of communism in Czechoslovakia began in the wake of student demonstrations on November 17, 1989. See Garton Ash (1990).

Director of the Institute, Valtr Komárek, a veteran of the 1968 movement, who was deputy prime minister in charge of economic affairs in the first post-communist government, advocated combining the transition to a market economy with structural reforms that foresaw the extensive role of the state in the economy. He was against immediate price and exchange rate liberalization and advocated gradual economic reform, particularly in the area of privatization, envisioning a case-by-case approach and a program of employee ownership (Meaney 1997: 108). [464]

His rival, Václav Klaus, espoused "Friedmanite-von Hayakian" free-market vision and Thatcherite policies (Saxonberg 1999: 401). The Klaus concept of reforms advocated the radical abolishment of central planning, rapid privatization, and full price liberalization. Klaus was against gradual transformation of the economy, or the so-called "third way,"[465] and against state involvement in the restructuring of the economy. His group of liberal economists promoted a "market without any adjectives." The debate was known as a contest between "radicals" and "gradualists."[466]

The Czech Civic Forum, along with its Slovak counterpart, the Public Against Violence, decisively won the first free elections in June 1990, which were considered to be a referendum against the communist regime (Stroehlein 1999: 3). By September

[464] For Komárek's views on the economic reform, see Komárek et al. (1990) and Komárek (1990).

[465] Klaus (2006) criticized Komárek and anti-communist dissidents led by Havel for advocating "a neocollectivist vision of society that rejected liberal democracy," for the lack of trust in the market and beliefs in "an enlightened economic center." See, also the interview with Klaus in Fund (1990).

[466] The group of gradualist economists included František Vlasák, the first chairman of the republic-level Czech government, Ota Šík who became economic advisor to the Czech President, the Pitthart group, and others. The group of economists with which Klaus surrounded himself when designing economic reform program consisted of Tomáš Ježek, later the first Czech minister of privatization; Dušan Tříska, deputy minister of finance; Ivan Kočárnik, later minister of finance, Karel Dyba, later minister of the economy, and Vladimír Dlouhý, the chairman of the Central Planning Office. For the examination of the debates on the initial transformation strategy between Klaus' radicals and Komárek's gradualists, see Adam (1993), Orenstein (2001), Schwartz (2006), Appel (2004), among others.

1990, Klaus had defeated the dissidents in the battle over the chairmanship of the Civic Forum. Klaus led a liberal minority within the government as the Czechoslovak minister of finance during the first Civic Forum government from December 1989 to June 1992.[467]

Klaus's group of economists proposed a liberal economic reform program, which won the support of the government. It became the official Scenario of Economic Reform (referred to as the "Capitalist Manifesto") and was ratified by the Parliament in September 1990 (Schwartz 2006: 130).[468] The reform package was based on restrictive reform policies to support the main reform goals, which included macroeconomic stabilization, liberalization, and westward reorientation of foreign trade. It was intended to represent a radical departure from central planning rather than an attempt at marginal improvements. While the Czechoslovak reform program was inspired by the earlier Balcerowitz big-bang reforms in Poland, it was less radical, partially to maintain public support for the program.[469] As Orenstein (2001: 68–72 and 1998: 4–5) argued, the final economic reform program combined orthodox macroeconomic policies and voucher privatization that would place a majority of shares in the hands of the people with social democratic welfare and labor protection measures to cope with social tensions resulting from radical economic reforms.[470]

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[467] The gradualist group was initially supported by a majority of Civic Forum representatives and former communists, while the Klaus group was in a weaker political position in the first post-communist governments in Czechoslovakia (Orenstein 2001: 68-9).

[468] In contrast, Komárek was unable to propose a cohesive reform program. He was replaced as a deputy prime minister by Václav Valeš, another economist from the 1968 movement, who completed a gradualist program entitled a "Strategy of Gradual Transition to a Market Economy in the ČSFR" (second variant of radical economic reform).

[469] Author's interview with Milena Horčicová, Director of the Department for Financial Policies, Ministry of Finance, June 15, 2006, Prague.

[470] According to Orenstein (1998 and 2004), Klaus was forced to agree to certain social-democratic elements to gain government support for his neoliberal economic reform program, e.g., legalization of collective bargaining as a mechanism for future wage regulation proposed by the Labor Ministry-inspired Scenario for Social Reform. The result was a "social-liberal" compromise, which was

Economic reforms in Czechoslovakia started in January 1991 and included five main pillars: price and foreign trade liberalization; internal convertibility of the currency; restrictive fiscal policy and tight monetary policy to maintain high interest rates and to restrict the growth of money supply; and massive and rapid privatization, mainly through the voucher scheme (Soukup, Taci and Matoušek 2004: 171).[471]

By the time the next elections took place in June 1992, the Civic Forum movement had split into several competing factions. Klaus founded the Civic Democratic Party (ODS) from the most conservative faction of the Forum. ODS won decisively the June 1992 elections and Klaus became the Prime Minister in the Czech Republic (table7.1). ODS formed a coalition with another post-Civic Forum party, the Civic Democratic Alliance (ODA) and with the Christian Democratic bloc (KDU-CSL), controlling 53 percent (105 out of 200) seats until the 1996 elections. The ODS-led government enjoyed stable popular support. It had great political freedom because the competition in the political system was weak and there were few checks on their political power; the powers of the president were restricted, the media were inexperienced and the civil society was undermined (Vachudová 2001: 336–7). The opposition parties of the fragmented left were weak and ineffective. The Czech communist party was thrown from power in 1989 and subsequently remained loyal to its communist ideology, and while the historic Social Democratic Party (CSSD) was

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neoliberal in macroeconomic policies and social democratic in its approach to labor relations and the welfare state. However, Schwartz (2006: 141) notes that these social democratic elements in the economic reform program resembled the "the preemptive social initiatives of Bismarck in Germany in the 1880s rather than the progressive measures of the modern Scandinavian welfare state."

[471] The introduction of internal convertibility of the Czechoslovak koruna at the beginning of 1991 meant a transition from foreign exchange rationing towards foreign exchange liberalization. The currency was declared internally convertible, and all foreign exchange transactions on the current account were liberalized (except for the transactions of physical persons who were domestic residents and all transactions involving inward foreign investments) and some capital account transactions (the inflow of foreign direct and portfolio investments as well as repatriation of profits) (Tošovský 1991, Drábek 1995, Erbenova and Holub 2006).

re-established in 1990, it gathered political strength only in the second half of the 1990s.[472] Moreover, the governments led by ODS tried to block the entry of other groups into the political arena to limit competition (Vachudova 2005: 36). Klaus tried to liberate the government from societal groups, such as Parliament, trade unions, or local governments. During his tenure, policy making in the government was in the hands of the Ministry of Finance and Ministry of Privatization (McDermott 2004: 192).[473]

Table 7.1: Governments in the Czech Republic, 1990–2002

Duration of Government	Prime Minister	Party Affiliation of Prime Minister
January 1, 1993[1]–July 4, 1996	Václav Klaus	Civic Democratic Party (Občanská Democratická Strana, ODS)
July 5, 1996–January 1,1998	Václav Klaus	Civic Democratic Party
January 2, 1998–July 16,1998	Josef Tošovský	Civic Democratic Party
July 17, 1998–July 14, 2002	Miloš Zeman	Czech Social Democratic Party (Česká Strana Sociálne Demokratická, CSSD)
July 15, 2002–July 19, 2004	Vladimír Špidla	Czech Social Democratic Party

[1]Date of division of Czechoslovakia, government in office as Czech state government since 2 July 1992

Debating the Need for a Fixed Exchange Rate Regime

The primary objective of the initial stabilization program was to contain inflationary pressures generated by the policies of liberalization and to assure the

[472] Komárek, who joined CSSD, withdrew from politics after the poor results of social democrats in the 1992 elections when they received 6.5 percent of the vote.

[473] Later, the Ministry of Privatization lost its superior position vis-à-vis other sectoral ministries since it had to invite them to participate in the process of decisions on privatization projects (Ježek 2006: 48).

stability of the exchange rate (Drábek et al 1994: 238).[474] Liberalization of the majority of prices in January 1991 resulted in a one-off increase in price level: the average annual inflation jumped to 57 percent in 1991 (Holub and Tůma 2006). The macroeconomic stabilization was exchange-rate based partly on the IMF-approved exchange rate based stabilization package: the exchange rate was fixed in a narrow band of plus or minus 1.5 percent against a basket of currencies of five major trading partners in December 1990.[475] Exchange rate served as a nominal anchor for stabilization policies and credibility import. Klaus (1997: 144) admitted that although the Czechoslovak reform program was not designed by foreign experts, its endorsement by the IMF sent a positive signal to world markets.

Initially, Klaus did not favor a fixed exchange rate regime (Klaus 1993: 531): "I was horrified at the very beginning with the idea of having fixed exchange rates. I remember at the same time that the IMF was shocked when I suggested a flexible exchange rate regime." He had particularly strong reservations against a currency board arrangement, which he considered a compensation for the lack of political responsibility or the inability of politicians to establish support for a "rational" economic policy (Klaus 1993).[476]

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[474] "Macroeconomic priority in the process of transformation is the blocking of inflation and this priority must to a reasonable extent override all other foundations of macroeconomic aims-economic growth, employment, and the balance of payments." See The Scenario of Economic Reform (1990: 5). Klaus (2000: 10) however, later modified his view on rapid disinflation, claiming that he has always considered it dangerous and irresponsible to potentially and dramatically slow down economic growth.

[475] As of December 18, 1990, the basket comprised the following currencies: U.S. dollar (31.34 percent), Deutsche mark (45.52 percent), Austrian schilling (12.25 percent), Swiss franc (6.55 percent), and pound sterling (4.24 percent). In fact, the official exchange rate of the Czechoslovak currency has been tied to a currency basket since the early 1980s (Hrnčíř 1999).

[476] Some members of the Klaus group, including Kočárník, have been consistent supporters of a float. Author's interview with Ivan Kočárník, former Minister of Finance (1992–1997), June 14, 2006, Prague.

The political debate over the initial exchange rate regime centered on two alternative views. One view, promoted by the IMF, focused on the crucial importance of stable nominal exchange rates, citing the examples of Poland and Latin American countries. The proponents of the second view underlined the favorable historical legacies of Czechoslovakia in contrast with other peggers, including a history of successful macroeconomic reforms and stable currency during the interwar period that did not necessitate a fixed regime.[477]

Ultimately, the fear of inflation and economic instability as well as the desire to import credibility from the countries with reputable central banks prevailed and a fixed regime was adopted, in spite of insufficient foreign exchange reserves.[478] The government that promised a commitment to stabilizing a sharply fluctuating post-communist economy arrived at the conclusion that a fixed regime was the only possible anchor of the economy and "the only fixed variable in the system," in which other variables underwent changes and fluctuations (Klaus 1994: 174). Nonetheless, the government has not made public any binding commitment to maintain the fixed exchange rate regime or a particular exchange rate level (Hrnčíř 1999: 309).

Yet, the most contentious debate, mainly between the representatives of the federal and the Czech governments, concerned the degree and level of fixity in the exchange rate. This debate reflected primarily anxiety over the consequences of liberalization for domestic exporters and the country's ability to successfully reorient its trade towards the West after the collapse of CMEA (Kutan and Brada 1998, Hrnčíř

[477] Author's interview with Miroslav Hrnčíř, Advisor to the Governor of the CNB, former member of the CNB Board, June 7, 2006, Prague.

[478] Author's interview with Vít Bárta, Advisor to the Vice-Governor of the CNB, June 9 and June 13, 2006, Prague. Initially, following the example of the Bundesbank, the Czechoslovak central bank experimented with monetary targeting but unsuccessfully. Author's interview with Zdeněk Tůma, Governor of the CNB, June 15, 2006, Prague.

1999). The contours of the internal convertibility regime of the currency were contested. There was a strong opposition to sweeping liberalization measures and calls for greater protection of the domestic market (Dědek 2000: 20). Klaus favored fast liberalization of foreign trade accompanied by an internal convertibility of the currency but only after a significant currency devaluation. He formulated the so-called "hypothesis of two transformation cushions"—an undervalued exchange rate and low real wages—that promised protection to domestic market players. According to this hypothesis, the exchange rate should be dramatically devalued before foreign trade liberalization and should stay below purchasing power parity to provide a bridge to a privatization period (Klaus 1994: 176, Klaus 1997: 67–68).[479]

Therefore, the exchange rate was devalued in four successive rounds of devaluation that took place in 1990–1991, altogether by more than 110 percent. It finally was pegged at 28 Czechoslovak koruny per U.S. dollar (Holub and Tůma 2006).[480] Devaluations were designed to encourage domestic exports and provide protection from fast penetration by imports of the domestic market. Thus, exchange rate, rather than tariffs, has been initially used to maintain external competitiveness.[481] The magnitude of devaluations, much below purchasing power parity, gave the government considerable time to protect domestic enterprises from foreign competition (Drábek 1995: 252–4 and 263). Devaluations made the environment for domestic industrial producers "softer." Domestic SOBs also benefited from this

[479] Additional factors were cited to support the case for currency devaluation including low level of foreign exchange reserves in the environment of liberalized foreign exchange flows and danger of a persistent real exchange rate appreciation as a result of high inflation (Hrnčíř 1999: 317).

[480] There was a lack of consensus concerning the initial exchange rate level, as well. Suggestions ranged from 16 Czechoslovak koruna per U.S. dollar (near the existing commercial rate) to 35-38 Czechoslovak koruna per U.S. dollar (close to the illegal parallel and shadow market rates) (Hrnčíř 1999: 317).

[481] Still, in addition to devaluations, the government also imposed a 20 percent import duty for selected commodities (Dědek 2000: 20, fn. 8).

exchange rate cushion. The large 55 percent devaluation, introduced in October 1990, was intended to protect banks that had experienced deteriorating liquidity (Hrnčíř 1999: 319).

Clearly, a fixed regime and low level of currency favored domestic exporters who benefited from a highly competitive exchange rate and protection against exchange rate risk, as well as domestic banks with vested interests in the profitability of their corporate clients.[482] These devaluations have proved to be excessive, however. They contributed to inflation shock and prevented the government from making a fixed exchange rate an effective anchor.[483]

Voucher Privatization and Foreign Capital

Alongside stabilization measures, the Scenario of Economic Reform also endorsed voucher or mass privatization as the primary privatization method. One of the principal motives behind the voucher privatization program was to build national capitalism by excluding foreign participation.[484] The Czech reformers warned that gradual privatization would encourage "spontaneous privatization" favoring the previous class of industrial *nomenklatura* which would sell state assets. This would lead to "a clearance sale of national property abroad" that was economically and politically unfeasible (Orenstein 1998: 9 and 2001: 77–79, Appel 2004: 55–56). It was

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[482] Author's interview with Pavel Mertlík, former Minister of Finance (1999–2001), Chief Economist in Raiffeisenbank, June 16, 2006, Prague.

[483] Author's interview with Oldřich Dědek, Professor of Economics at Charles University, former Advisor to the Governor of the CNB and to the Prime Minister of the Czech Republic, Vice-Governor of the CNB (1999–2005), June 12 and 10, 2006, Prague; author's interview with Miroslav Hrnčíř, Advisor to the Governor of CNB and former member of the CNB Board, June 7, 2006, Prague.

[484] Additionally, the goal of the voucher method was motivated by its speed, the lack of domestic capital, and the intention to create the first (but not the last) domestic owners of capital. Author's interview with Oldřich Deděk, Professor of Economics at Charles University, former Advisor to the Governor of the CNB and to the Prime Minister of the Czech Republic, Vice-Governor of the CNB (1999–2005), June 12 and 10, 2006, Prague.

uncertain if public opinion would tolerate mass transfers of national property to foreigners (Ježek 2006: 45). A particular resentment was felt towards Germans: Czechs feared the prospect of becoming low-wage subcontractors for German enterprises (Horowitz and Petráš 2003: 257). As Klvačová (1991: 1) observed, Czechoslovak privatization was characterized by an aversion (manifested above all from the side of real and potential entrepreneurs) to the sale of national property to foreign capital."[485] Klaus tried to promote the so-called "Czech way," or national capitalism favoring domestic over foreign capital.[486] The only enterprise privatized through direct sales to a foreign investor, prior to the implementation of voucher privatization, was Volkswagen's deal with the car manufacturer Škoda Mladá Boleslav.

The Klaus privatization team included his deputy and his former colleague from the Institute of Economic Forecasting Dušan Tříska and Tomáš Ježek (who later became the first Minister for Privatization), the three fathers of Czech (mass) voucher privatization.[487] They drafted a Large Privatization Law, approved by the Federal Parliament in February 1991.[488] The law promoted widespread, speedy, and free

[485] The government's reluctance to allow the entry of foreign investors has historical origins. In 1920, after the collapse of the Austro-Hungarian empire, Czechoslovakia introduced a Nostrification Law that required enterprises with assets in Czechoslovakia to incorporate there (Tschoegl 2003: 48).

[486] See Myant (2003) for an analysis of the "Czech way" of transformation.

[487] In fact, Jan Švejnar, a Czech émigré economist, then teaching at the University of Pittsburgh (and currently at the University of Michigan) became credited with introducing a version of mass privatization into the Czech reform debate. In February 1990, Švejnar presented a paper proposing rapid privatization of property at a meeting of economists on reform strategies in the Kolodeje castle outside of Prague. Author's interview with Karel Kříž, former Advisor to the Chairman of the Executive Committee of the National Property Fund, June 5, 2006, Prague; author's interview with Tomáš Ježek, former Minister of Privatization (1990–1992) and President of the National Property Fund (1992–1994), June 20, 2006, Prague.

[488] Privatization in Czechoslovakia was pursued under three programs: restitution, small-scale privatization, and large-scale privatization through vouchers. The first two programs started already in 1990. Restitution dealt with private property that had been nationalized by the communist regime after 1948. There have been at least 200 thousand claims for agricultural land and 70 thousand apartment buildings to be returned to their former owners. Small-scale privatization, which officially ended by

transfer of property rather than direct sales.[489] The government proceeded with voucher privatization in spite of its disagreement with the World Bank, which initially did not support this privatization method (Drábek 1995: 247).[490] Trade unions and Social Democrats championed management employee buyouts, wherein the enterprise would be owned by workers and management.[491]

The Ministry of Privatization, responsible for evaluating privatization plans, and the National Property Fund (*Fond Narodního Majetku*, FNM) were established; they were charged to administer state property prior to privatization and to implement the privatization of this property. The members of the FNM Board were mainly bankers because they were considered to be the only credible "suppliers" of financial experts at the time (Ježek 2006: 67–68). The process of large-scale privatization through vouchers started in spring 1991. The largest enterprises were transformed into joint stock companies, the shares of which were distributed within voucher privatization.[492] All Czech and Slovak citizens over the age of 18 could buy a package

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1993, concerned small economic units like retail stores, restaurants, and small industrial enterprises sold at public auction, while bidding was restricted to resident citizens and was mostly financed by domestic banks (Kočenda 1999).

[489] The process of public legitimization of voucher privatization was fast: in May 1990, the Government of National Understanding approved a schedule to launch voucher privatization; in September 1990, the Federal Parliament approved voucher privatization as the main privatization method in the Scenario of Economic Reform; and in February 1991, the Federal Assembly passed the Large Privatization Law (the Act on the Conditions of Transfer of State Property to Other Persons no. 92/1991 Coll.) (Schwartz 2006: 129).

[490] There were some disagreements among the privatizers over the privatization methods. Deputy Finance Minister Tříska's formulated the so-called "97+3" proposal, supported by Klaus, suggesting that 97 percent of the shares should be included in voucher privatization and only 3 percent of shares for restitution of private property to original owners. Instead, Ježek called for the use of mixed privatization methods, believing that certain industries would benefit from foreign strategic investments (Appel 2004: 53-60, Husák 1997). For some excellent examinations of privatization in the Czech Republic, see Ježek (2006), Coffee (1996), Appel (2004), Schwartz (2006), Orenstein (2004).

[491] Author's interview with Milena Horčicová, Director of the Department for Financial Policies, Ministry of Finance, June 15, 2008, Prague.

[492] The Czechoslovak government selected around six thousand large enterprises for privatization: 4,400 in the Czech Republic and 1,600 in Slovakia (Švejnar and Singer 1994: 44). Enterprises were

of vouchers for a nominal fee.[493] The voucher holders could use these vouchers to acquire shares in enterprises in a public auction. Voucher privatization excluded foreigners and prohibited foreigners from purchasing vouchers from the voucher holders.[494] The populist distribution of vouchers, promising their holders large profits, helped ODS to win the elections in 1992 and 1996.[495]

In the first wave of mass privatization (five rounds) that started in October 1992 and ended in June 1993, 988 enterprises participated. In the second wave (six rounds) that started in November 1993 and ended in December 1994 and took place exclusively in the Czech Republic (the Mečiar government cancelled it in Slovakia), 861 enterprises participated (Coffee 1996: 123). In 1996, the government closed the Ministry of Privatization but transferred its responsibilities to the FNM and the Ministry of Finance. By the end of 1997, 58 percent of large enterprises had been privatized through the voucher system, while only 14 percent were privatized through direct sales (EBRD Transition Report 1998: 162).

In spite of this impressive scale of enterprises that was privatized through vouchers, the government did not privatize the enterprises entirely and kept its

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divided into four groups: enterprises to be privatized in the first and second waves of large-scale privatization; enterprises to be privatized later; and enterprises to be liquidated.

[493] In both waves of privatization, each participant could purchase a book of 1,000 voucher points for a fee of thousand Czechoslovak koruna (equivalent to 35 U.S. dollars), or about the average weekly wage in 1992. A large number of citizens participated in the voucher scheme: 5.95 million (and 2.59 in the Slovak republic) in the first wave; and 6.16 million out of a population of 10 million in the Czech Republic in the second wave. In the first wave of voucher privatization, 92.8 percent of shares were sold. After the mass privatization program was completed, almost 75 percent of productive capacity was transferred to the private sector (Kočenda 1999: 24).

[494] It was also difficult for a foreign buyer's project to get approved because it had to be approved by the government of the respective republic, while projects proposed by domestic buyers were decided by the founding ministry and the Ministry of Privatization (Kočenda 1999: 4). There were 442 sales to foreign strategic investors registered outside of voucher privatization, but these were mostly small enterprises (Claessens and Djankov 1999: 500).

[495] Author's interview with Petr Dufek, Director of Macroeconomic Research, Czechoslovak Commercial Bank, June 16, 2006, Prague.

involvement through the FNM in a large number of enterprises and banks. The government maintained control over enterprises through the presence of top ministry officials in their statutory bodies. It was able to exercise its influence through various means, for example, through the number of shares or the portion of the state property that was represented by voting rights. The government held "golden shares" in over 20 percent of enterprises, allowing it to veto any major changes in an enterprise. Finally, the government kept majority or controlling stakes in forty "strategic enterprises" (banks, mines, energy, insurance) (Kreuzbergova 2006: 168, Palda 1997: 87). The government repeatedly tried to prevent bankruptcies of strategic enterprises that employed a large number of workers (Appel 2004: 64), so after voucher privatization, the state still maintained its influence over a significant part of the Czech economy.[496]

It was not only the government that shaped privatization and its outcomes. Nomenklatura managers who had access to resources and capital were in a position to influence the course of privatization in their favor. The Ministry of Finance reassured incumbent industrialists that voucher privatization would not undermine the industrialists' control over enterprises but on the contrary, the dispersed ownership structure, which does not translate into active owners, would allow them greater independence in managing their enterprises. As a result, while the reformers officially claimed that the voucher method was a way to weaken the former industrial nomeklatura, it was actually the favored choice for managers of state-owned enterprises (McMaster 2001: 27, Appel 2004: 131). For many nomenklatura managers, voucher privatization was also a protection from being taken over by foreign owners, who would replace them with Western managers (Schwartz 2006: 206).

[496] This paragraph relies mostly on the account of Kočenda (1999). In 1998, the state was still involved in 369 companies and the relative book value of all enterprises, where it has preserved a share over 50 percent, reached 41 percent.

Finally, as I show in the subsequent section, the voucher method of divestiture of state assets also ensured that large SOBs established themselves as dominant players in the transition politics for two reasons. First, the largest SOBs became, through their investment funds, the core investors in a large part of Czech industry. Thus, the government maintained an ownership position indirectly in large blocks of nominally privatized enterprises through bank-owned IPFs. Second, banks represented almost the only source of domestic capital given the underdeveloped capital market and reluctance about foreign capital (Kreuzbergova 2006: 163–4).

Banking Socialism (1990–1997)

The banking sector in Czechoslovakia during the communist era consisted of a state-owned *monobank*, the State Bank of Czechoslovakia (SBCS). SBCS served as both the central bank as well as the institution for channeling commercial credit and providing depository and payment services to state-owned enterprises and four specialized banks. The first specialized bank was the Czechoslovak State Savings Bank, which split into the Czech Savings Bank (Česká Spořitelna, CS) operating in the Czech Republic and the Slovak Savings Bank (Slovenská Sporiteľňa) operating in the Slovak Republic after Czechoslovakia adopted a federal structure in 1968. These two banks provided depository services and extended credit to individuals. The second bank, the Investment Bank, later the Investment and Postal Bank (Investiční a Poštovní Banka, IPB), was established in 1948 to promote development and investments involving foreign enterprises.[497] Third, the Czechoslovak Trade Bank (Československá Obchodní Banka, CSOB) was a specialized bank established in 1965 as a foreign trade bank. Finally, the fourth specialized bank was Živnostenská Banka (ZB), established in 1868 to focus on small business and to conduct retail foreign

[497] At the end of 1993, a merger between Investiční banka and Poštovní banka gave rise to Investiční a Poštovní banka.

currency operations. All these banks remained under state control at the beginning of the transition. The central bank and commercial bank functions of SBCS were later divided into the Commercial Bank (Komerční Banka, KB) in the Czech Republic and the General Credit Bank (Všeobecná a Úverová Banka,VUB) in the Slovak Republic. Reforms of the Czechoslovak banking sector began on January 1, 1990 with the establishment of a two-tier banking sector, liberalization of bank entry, and voucher privatization of banks and industries.[498]

The first banking legislation was adopted two days before the Velvet Revolution and was simply a modified product of the communist regime. The rules for establishing a new bank were very liberal. Enterprises were able to create their own banks using a bank loan. The minimum basic capital required for establishing a new bank was only 50 million Czechoslovak koruna (1.8 million U.S. dollars at the 1990 exchange rate) (Mejstřík, Dvořáková, and Neprašová 2004: 23). As a result of inadequate financial regulation, there were already 23 banks registered in December 1990 and the number of banks jumped to 57 by mid-1995, peaking at the end of 1991–1993 (Procházka 1996: 26). Most of these new private banks were small, undercapitalized and inefficient. They usually offered the highest interest rates to attract deposits and engaged in questionable insider lending (Nollen, Kudrna and Pazderník 2005: 368).

The first post-communist law on the central bank also reflected a centrally planned approach on the part of its authors. As a result, the central bank remained entirely subordinated to the government until February 1992 when a new law took effect.[499] The new law granted the SBCS independence as well as the authority to

[498] See Act No. 158/1989 Coll. On Banks and Savings Banks and Act No. 130/1989 Coll. on SBCS, passed on November 15, 1989 (coming into force in January 1990). For detailed analyses of the evolution of the Czech banking system, see Mervart (1998), Mejstřík (2004).

[499] Act No. 22/1992 on SBCS.

supervise and license commercial banks. After the dissolution of Czechoslovakia on January 1, 1993, the Czech National Bank (*Česká národní banka,* CNB) became the successor of SBCS. The new central bank law further strengthened the political independence of the CNB (Soukup, Taci, and Matoušek 2004: 172–173).[500] The institutional powers of the CNB were strong: it was made responsible for setting monetary policy (Article 2) as well as for "proclaiming" the exchange rate for the Czech currency vis-à-vis foreign currencies (Art 35) (Koch 1997: 7). In addition, the main goal of CNB, to ensure the stability of the national currency, was incorporated into the 1993 Constitution.

Originally, banks were to be excluded from voucher privatization and instead were sold via direct sales. But the Czechoslovak (and the Czech) governments finally choose not to sell off the "Big Four" SOBs (KB, CS, IPB, and CSOB) to foreign investors and instead to include three of them in voucher privatization among the strategic enterprises, with the state retaining large shareholdings. The privatization program specified that the government was to retain control of at least a 40 percent stake in the banks and to limit foreign investments to a maximum of 25 percent, with no single foreign investor being allowed to acquire more than a 10 percent stake (Kreuzbergova 2006: 167). At the end, only a minority of shares of the big banks was put into voucher privatization, and the government retained control as the single largest shareholder with stakes ranging from 47 percent to 60 percent. Although the state lost its majority in IPB in 1993, it still kept a significant share of 30 percent until 1998 (table 7.2). While some banks had their own plans for privatization involving institutional and foreign strategic investors, they quickly acquiesced on and even

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[500] Act No. 6/1993 on CNB stipulated that the Governor and other members of the Bank Board could be appointed and dismissed by the President of the Republic, only.

promoted the idea that they should be included in voucher privatization. Banks may have reasoned that after voucher privatization was completed, they would be able to increase capitalization by issuing new shares for cash (Mortimer 1995: 103–104).

Table 7.2: Share of State Assets in Large SOBs

Financial Institution	State share (as of April 26, 1996)
Investiční a Poštovní Banka	36.30
Komerční Banka	48.74
Československá a Obchodní Banka	90.10
Česká Spořitelna	45.00
Česká pojišťovna	26.27

Source: Schwartz (2006: 209).

Klaus espoused free-market orthodoxy but he diverged from it in designing banking reforms. From the outset, Klaus's economic reform program was conceived as a strategy for national development, appealing to an old Czech tradition from the 19th century when the development of the Czech state (within the Austro-Hungarian Empire) was pursued by promoting Czech businesses through Czech banks (Orenstein 1997: 9).[501] The government was reluctant to sell the domestic banks ("family silver") to foreign investors. The government's plan for big Czech banks was that the banks should finance the transition. Banks were practically the only source of enterprise

[501] Teichova (quoted in Rao and Hirsch 2003: 260, fn. 3) notes that during the inter-war period, "numerous industrial companies clustered around big banks, tied to them either by credits or direct investment. In this way, large joint-stock banks threw a net of relationships of various degrees of dependency over almost all branches of production in the country." Nationality-based credit unions financed various agricultural development projects, and the Czech grand bourgeoisie developed new heavy industries, such as Škoda Works in Plzeň with strong links with the Czech banks, namely ZB, which became a powerful national symbol (Teichova 1988 quoted in Orenstein 2001: 77).

finance because privatization did not bring new capital to enterprises, capital markets were underdeveloped, and foreign investments restricted (Kreuzbergova 2006). Because of this crucial role that banks had in the transition, the government envisaged keeping them under state control during the transformation of industry in order to play an active role in credit policy. Klaus intended to preserve the soft credit system and was reluctant to sell majority shares of the Czech banks fearing that new foreign owners would conduct conservative, restrictive credit policies vis-à-vis domestic enterprises that would lead to high unemployment.[502] Snyder and Kormendi (1997), who thoroughly studied the KB case, explain that the government's decision against a meaningful privatization of this most important Czech bank was to preserve the channels to pursue credit allocation for its politically vested clients.[503] In Klaus' words:[504]

> The reason for the delay of big banks' privatization did not consist of ideological fears. It was a purely practical consideration that private banks will behave too prudently … and de facto not dip into the real economy …. It is possible to be such a parasite … I was always very afraid that while attempting to follow their private interests, the loan channels would be blocked ….

Therefore, although the 1992 banking law allowed foreign banks to establish branches in the former Czechoslovakia, foreign investors could not acquire controlling stakes in major Czech SOBs. The prevalent strategy for foreign bank entry in the

[502] Author's interview with Tomáš Ježek, former Minister of Privatization (1990–1992) and President of the National Property Fund (1992–1994), June 20, 2006, Prague.

[503] For a detailed account of the privatization of KB, see also Dlouhý (2004).

[504] Klaus quoted in Nollen, Kudrna and Pazderník (2005: 366). Klaus made similar comments during his luncheon address at the Cato Institute in March 1992.

initial years of transition was to set a branch.[505] After the end of 1993 for more than two years, the government applied a moratorium on licensing foreign banks to limit the exposure of domestic banks to competition (Schwartz 1997). The official explanation was that domestic banks needed "breathing space" to consolidate and restructure (Konopielko 1999). By the end of 1996, foreign bank assets in the Czech banking sector amounted to only 8 percent of total assets.

The only Czech bank privatized to a foreign strategic investor in the early 1990s was a small bank, ZB. In 1992, the German BHF-BANK acquired a 40 percent stake in ZB. The new bank owner did not tolerate imprudent lending.[506] Klaus strongly disapproved of the privatization of ZB: he called it a "horrifying example" and criticized the bank for being "too prudent" and unwilling to "dirty its hands with the real economy" (Kreuzbergova 2006: 177, fn. 2).

Investment Privatization Funds, Cross-Ownership, and Moral Hazard

Contrary to expectations, voucher privatization resulted in a highly concentrated structure of control rights due to the emergence of IPFs controlled by financial institutions, particularly by large SOBs and insurance companies, as well as by privately-owned emerging financial groups that accumulated their capital during the privatization.[507] After the first wave of privatization, the top thirteen privatization

[505] Among the first foreign banks that established branches were Bank Austria, Creditanstalt, BNP-Dresdner, and Citibank.

[506] The IFC acquired 12 percent and private individuals and Czech investment funds acquired the remaining 48 percent. In 1998, Bankgesellschaft Berlin took over BHF-BANK's stake and increased its ownership to 85 percent. Finally, in 2001 Bankgesellschaft Berlin sold its stake to Italy's Unicredito (Tschoegl 2003: 48).

[507] Managers of large SOBs perceived IPFs controlled by non-bank institutions as vehicles for outsiders to acquire their bank shares. Some financial groups began to raid the shares of enterprises held in IPFs of the major Czech banks. The prominent example was the Motoinvest group, a shady nonbank fund, which acquired substantial stakes in the IPFs of KB, CSOB, ZB, and Agrobanka. Takeover threats seemed to be an important motivation for SOBs to establish their own IPFs. IB was the first bank to establish an investment subsidiary in November 1990 before any legal provisions concerning IPFs were

funds gained control of 55 percent vouchers, enabling these funds to control 75 percent of the board seats in Czech enterprises privatized in the first wave (Appel and Gould 2000: 1114; Appel 2004: 131) (table 7.3).[508] Out of the top IPFs, nine were founded and controlled by the major domestic banks and attracted vouchers to control nearly 30 percent of the shares of privatized enterprises (Appel 2004: 62). The state, represented by FNM, was a dominant investor in bank-led IPFs. Because the government owned controlling stakes in banks, it retained a large ownership stake and the potential for involvement in Czech industry. Some note that privatization through vouchers actually led to "renationalization" by SOBs (Mejstřík, Dvořáková, and Neprašová 2004: 33–34).

Initially, there was a complete absence of regulation concerning the establishment and functioning of IPFs until the adoption of the Law on Investment Funds and Companies in April 1992. However, this regulatory framework came late, was inadequate, and was not properly enforced.[509] As a result, over 450 IPFs and 44 pension funds were issued a license by the Federal Ministry of Finance. While the law prohibited IPFs established by a bank from purchasing the shares of its founder or other banks, banks circumvented this regulation by setting up investment companies as wholly owned subsidiaries that established IPFs, rather than banks themselves (Rao and Hirsch 2003: 261).

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enacted, and later set up eleven funds. The largest IPF was established by CS (Rao and Hirsch 2003, Schwartz 2006).

[508] IPFs acquired 71 percent of total vouchers after the first wave of privatization and 63.5 percent in the second wave (Mejstřík 1997). In Slovakia after the first wave, the top fifteen Slovak privatization funds obtained 40 percent of vouchers (Appel 2004: 131).

[509] IPFs were originally established under the Government Decree on Investment Companies and Privatization Investment Funds No. 383/1991 of 5 September 1991. The decree defined IPFs as joint stock companies (roughly equivalent to a U.S. limited liability corporation) established by a founder to collect independent citizens' vouchers and invest these vouchers in a mass privatization scheme. Unlike its Czech counterpart, the Slovak Ministry of Privatization adopted a legal framework strictly regulating IPFs by 1991.

Table 7.3: Largest IPFs in the First Wave of Mass Privatization

Group	Shares Held (mm)	Total Shares in Funds (%)
SIS, Czech Savings Bank	21.4	12.2
PIAS (První investiční akciová společnost, IPB)	13.6	7.27
Harvard Capital Consulting Investment Firm*	15.2	8.56
VUB	12.0	6.81
IKS, Komerční banka	11.9	6.78
KIS, Česká pojišťovna	7.6	4.33
Investment firm Slovenské Investície*	6.4	3.66
Slovak Savings Bank and VSZ (steel company)	7.7	4.48
Investment firm of Creditanstalt Bank*	3.6	2.05
Slovenská investiční banka	4.6	2.63
PPF*	4.9	2.80
Živnostenská banka*	1.09	0.07
Slovak Insurance Company	4.4	2.48
Agrobanka*	3.9	2.24
Top 14 groups	119.1	67.71
Total Investment Privatization Funds	175.0	100.0

*Fully private IPFs.

Source: Marcinčin, Mejstřík, Mládek calculations from data of the Czech Fund of National Property in JP Morgan Overview of the Czech Banking Sector, December 2003: 69.

Competition in the banking sector was therefore further restricted by cross ownership, for banking investment subsidiaries acquired significant portions of shares not only in industrial enterprises but also in other banks. For example, KB and IPB together owned 12.7 percent of the shares of CS, and CS and IPB together owned 15.7 percent of the shares of KB (table 7.4). In addition, some large enterprises also controlled IPFs or owned large stakes in other enterprises. The voucher privatization thus did not transfer property rights from the state to private hands but created a "recombinant property" through IFPs. This state of affairs resulted in the prevalence of

cross-ownership networks of banks, industries, and the state and the prominent position of banks in these networks (Stark 1996, Stark and Bruszt 1998).[510]

Table 7.4: Cross-ownership in the Czech and Slovak Banking Sectors

Names of financial groups of investment co-owners of shares	Percentage of shares of financial institutions privatized through vouchers (in %)							
	CS	IPB	KB	CP	ZB	VUB	IRB	SP
Česká spořitelna (CS)	–	0.5	4.9	2.0	5.0	–	–	–
Investiční a poštovní banka (IPB)	8.8	17.0	10.8	4.1	10.4	–	0.4	–
Komerční banka (KB)	3.9	–	3.4	–	–	4.2	–	–
Česká pojišťovna (CP)	0.2	3.0	0.7	1.0	4.0	–	–	–
Živnostenská banka (ZB)	–	–	–	–	–	–	–	–
Všeobecná úverová banka (VUB)	1.6	3.5	4.3	–	2.5	10.8	4.1	–
Investičná a Rozvojová Banka (IRB)	0.8	6.9	1.1	–	0.6	18.8	18.8	15.8
Slovenská poisťovňa (SP)	0.3	0.4	0.1	–	0.3	0.9	–	4.7
Československá obchodní banka	0.2	1.1	0.3	–	0.6	–	–	–
Harvard Capital and Consulting	12.9	–	17.6	5.0	–	–	–	–
Agrobanka	0.6	1.1	0.3	0.1	0.6	0.4	–	–
PPF	–	0.6	–	–	0.3	–	–	–
SSK	0.3	0.9	0.4	0.1	–	3.0	–	–
Total of 13 groups	29.6	35.0	43.9	12.3	24.3	38.1	23.3	20.5
Total percentage of shares privatized through vouchers	37.0	49.6	53.0	15.0	41.1	49.2	50.1	48.0

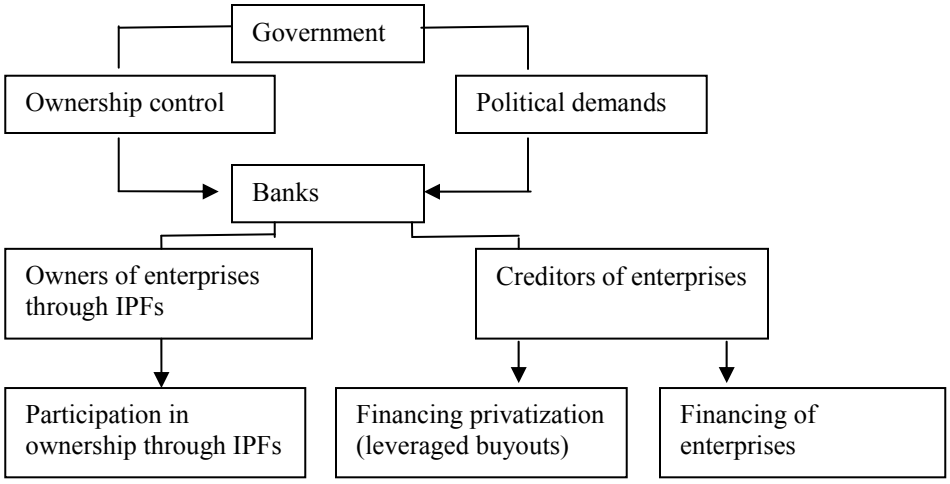
Source: Mejstřík, Dvořáková, Neprašová (2004: 57).

In sum, the voucher privatization and the financial development policies of the Czech government led to so-called *banking socialism*,[511] which is a financial system characterized by indirect control through IPFs of privatized enterprises by banks, which remained owned by the government (figure 7.1 illustrates a complex web of

[510] Some Czech commentators call the outcome of the voucher method "privatization incest." Author's interview with Petr Dufek, Director of Macroeconomic Research of CSOB, June 16, 2006, Prague.

[511] This term was used by most of my interviewees as well as in the secondary literature to characterize the development of the financial system in the Czech Republic, which was inherently associated with mass privatization.

relationships among the government, banks, and enterprises in banking socialism). The outcome was a pervasive moral hazard dilemma, which rose from the role of the government in the financial sector. Banks became an instrument of governmental policy. The government encouraged expansive bank lending to prevent unemployment and bankruptcy of insolvent enterprises in return for the promise of direct bailouts to banks in case of distress or indirect bailouts through their corporate borrowers, as well as regulatory bank protection. This policy helped the ODS-led governments to remain highly popular and to neutralize political opposition to reform. [512] The second source of a moral hazard stemmed from the dual role of banks as the owners and creditors of enterprises that reduced motivation to establish prudential banking practices.



Source: Adapted from Kreuzbergova (2006: 165).

Figure 7.1: Banking socialism (1990–1997)

[512] I disagree with McDermott's (2007) argument who characterized the Czech approach to financial reforms in the 1990s as a case of "extreme depoliticization." On the contrary, this chapter shows that the approach of the ODS-led government to banking reform was highly politicized.

After voucher privatization, the Czech financial system remained dominated by the "Big Four," considered to be "the heart of the economy."[513] These banks and the Consolidation Bank accounted for 76 percent of banking assets, 83 percent of deposits, and 80 percent of loans in 1995. They employed 80 percent of the banking workforce. Many of the newly established private domestic banks were also controlled by SOBs (Snyder and Kormendi 1997: 110, Desai 1995: 24).

The cross-ownership structures provided the government with multiple channels to influence the policies of banks (Nollen, Kudrna, and Pazderník 2005: 366, Snyder and Kormendi 197: 105). The government exercised its ownership officially through the FNM, which placed its representatives on bank boards. FNM represented the government at shareholder meetings and exerted direct control over the bank's senior management. FNM could replace the bank's management, determine its dividends, define strategic objectives, and intervene in credit policies. The supervisory board of FNM itself was nominated by the Ministry of Finance, which also held board memberships in the banks. Furthermore, members of the Czech parliament represented the interests of its constituents, mainly state-owned enterprises, which needed loans for operational financing as well as for restructuring. The last potential channel of influence represented the central bank in its role of regulator. Nonetheless, the CNB during the governorship of Josef Tošovský had established itself as a conservative, independent institution that sought to "keep distance" from the banks (table 7.5).[514]

[513] Author's interview with Miroslav Hrnčíř, Advisor to the Governor of CNB, former member of the CNB Board, June 7, 2006, Prague.

[514] Milena Horčicová, Director of the Department for Financial Policies, Ministry of Finance, June 15, 2008, Prague.

Table 7.5: Governors of the Czech National Bank, 1989–2007

Governor	Tenure	Background
Josef Tošovský	December 29, 1989 appointed SBCS President, SBCS Governor from April 21, 1992, January 1, 1993 appointed Governor of CNB	Central banker (State Bank of Czechoslovakia)
Pavel Kysilka, Vice-Governor delegated the management of CNB	December 17, 1997–June 23, 1998 when Tošovský holds the office of Prime Minister	Central banker (State Bank of Czechoslovakia)
Zdeněk Tůma	December 1, 2000	Financier

Source: Czech National Bank

The Klaus governing party, ODS, had close relationships with IPFs, shady businessmen, and big banks (Schwarz 2006).[515] The managers of SOBs were members of former banking-industrial nomenklatura. They came from the socialist monobank and retained their positions until the late 1990s (Palda 1997: 89). For example, Richard Salzmann, a former senior executive in SBCS, was appointed in early 1991 as Chief Executive Officer and Chairman of KB. He was a prominent member of the ODS political party and a member of the Klaus group. The fact that he was also the first chairman of the Prague Stock Exchange represented a conflict of interest between the regulators and regulated institutions (Schwartz 2006: 245).

The Czech government, in its role of principal, and the banks' senior management, as the government's agents, followed an "implicit contract" based on public statements and personnel appointments rather than on direct political

[515] According to some commentators, all Czech ministers of finance had direct relationships with commercial bankers. Author's interview with Pavel Štěpánek, Deputy Director of the Czech Banking Association, June 20, 2006, Prague. For example, there were regular dinners among Prime Minister Klaus, Finance Minister Kočárník, NBS governor Tošovský, and the chairmen of the big four banks. Author's interview with Ivan Kočárník, former Minister of Finance (1992-1997), June 14, 2006, Prague.

instructions. The contract focused on government objectives that involved subsidizing key political constituencies (Snyder and Kormendi 1997). Under the assumption that the government would eventually bail them out, banks were granting credits to financially distressed enterprises and these enterprises continued to sell products to each other on credit to avoid insolvency.

Moreover, the government decided to extend "privatization" loans through SOBs, in exchange for equity, to domestic entrepreneurs in order to provide them with enough financial resources to privatize state-owned enterprises.[516] While credit limits and high interest rates were used as elements of anti-inflationary policy, credits for privatization were exempted from credit ceilings to stimulate industries (Drábek, Janáček, and Tůma 1994: 169–170). As the World Bank Report (1999) noted, a significant part of the privatization of enterprises was leveraged, thus generating enterprises with no capital because shares of an acquired enterprise were usually used as collateral for granted loans. As a result, industrial enterprises became overly dependent on banks and (short-term) bank credit. The big SOBs were able to influence a significant part of the enterprise sector because they were practically the only source of financing in the country. Banks were tied to enterprises not only by large outstanding loans but credit relationships that often got turned into ownership relationships through debt-equity swaps.[517] Large SOBs acquired indirectly significant share portions of many domestic enterprises.

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[516] The Scenario of Economic Reforms did not foresee an important role for the banks in privatization, however. According to the Scenario, it was "impossible to assure that the domestic banks will extend credit to the domestic population for the purchase of property due to the banks' capital inadequacies" (1990: 17, quoted in Schwartz 2006: fn. 22).

[517] Alternatively, as Mlčoch (quoted in Kreuzbergerova 2006: 169) explains, when an enterprise capital became negative due to strong indebtedness with the bank, the bank controlled the enterprise as if it possessed it, resulting in a situation of a *de facto* ownership.

In their dual role as the owners and creditors of industrial enterprises, banks were facing conflicts of interest. Of course, bank as creditors should apply prudent credit criteria. However, banks as owners might want to promote the competitiveness of enterprises or prevent the closing down of failing enterprises and thus would grant credit under lax credit conditions, relax credit repayments, or roll over loans (Nollen, Kudrna, and Pazdernik 2005: 370). The banks often provided "co-owner loans" to enterprises: if a borrower had difficulty paying back a loan to a co-owner bank, the bank provided another loan rather than initiating bankruptcy proceedings. Banks have sometimes used their dual role as creditors and owners to extract rents from a healthy enterprise to bail out failing projects (Desai and Plocková 1997). The new small private banks that emerged in the environment of weak regulation and bank supervision provided the so-called "tunneling" loans that represented "gifts" to the borrowers who were either the bank's managers or shareholders themselves. As one Czech commentator pointed out, "The government did not privatize the banks but the borrowers privatized the money" of the banks (Havel 2004).

Imprudent credit practices of domestic banks, whose decisions reflected political interests, thus manifested themselves by lending to risky enterprises and rolling over troubled loans to politically important clients, instead of exerting pressure on these delinquent debtors. Credit and investment activities of banks comprised a substantial moral hazard because they were financed from deposits; therefore, neither enterprises nor banks risked their own capital (Kreuzbergova 2006: 170).

Managers of SOBs extended a large number of "soft" loans in order to meet the expectations of government politicians who appointed them in return for government regulatory protection, including protection from foreign competition.[518]

[518] Author's interview with Vít Bárta, Advisor to the Vice-Governor of CNB, June 9 and 13, 2006, Prague.

The regulatory approach of Prime Minister Klaus and the Ministry of Finance, which concentrated much of the regulatory authority, derived from a belief in the philosophy of *laissez faire* and the conviction that the state should abstain from close regulation of markets (Schwartz 2006: 212–213). Banks also lobbied state officials against bank and capital market regulation.[519] As a result, the Czech regulatory framework in the areas of capital regulations, loan insider lending, loan collateralization and classification stringency, and effective bankruptcy procedures was either weak or absent (Barth, Caprio, and Levine 2002).[520] Banks often intervened on behalf of their corporate clients, particularly in the area of bankruptcy legislation. The government anti-bankruptcy policy was based on the banks' liberal credit policies toward the insolvent state-owned enterprises in order to prevent unemployment. "Too big to fail" considerations united Czech bankers and Czech industrialists on the same side when lobbying for regulation, subsidies, or loan forgiveness (Schwartz 2006: 249).

In sum, as I will illustrate in the following section, banking socialism generated incentives for moral hazard in the financial sector, whose main symptoms were soft bank credit, the accumulation of large shares of bad loans, insufficient financial regulation, the abuse of insider trading, non-transparent transfers of ownership, and various forms of asset stripping in privatized enterprises (so-called tunnelling), which gravitated to financial instability and unsustainable policy for a currency peg.

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[519] Author's interview with Jan Mládek, former Minister of Agriculture (2005-2006), First Deputy Minister of Finance (1999-2001), and Deputy Minister of the Federal Ministry of Economy (1991-92), June 9, 2006, Prague. The leading role in these lobbying efforts was played by IPB because its Chairman Libor Procházka enjoyed a close personal relationship with Klaus. Author's interview with Tomáš Ježek, former Minister of Privatization of the Czech Republic (1990–1992) and President of the National Property Fund (1992–1994), June 20, 2006, Prague.

[520] Although the government enacted a bankruptcy law in 1991, subsequent measures prevented this law from being applied until the middle of 1993 (Koch 1997: 14).

The End of the Czech Miracle: Financial Turmoil in 1997

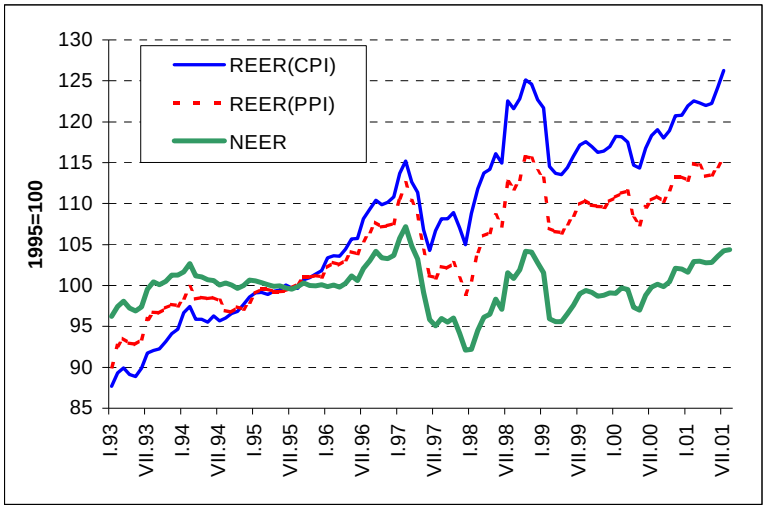
A fixed exchange rate and the restrictive monetary policy of the CNB were successful in stabilizing inflation at around a ten percent level in 1992. Growth resumed after a temporary stagnation in 1993, a central government budget was close to being balanced, and unemployment was low. After the "velvet divorce" of the Czechoslovakian Federation on January 1, 1993, a monetary union and common currency were created to mitigate the economic effects of the split,[521] but the Czechoslovakian monetary union officially ceased to exist and the new independent currencies became valid by February 8, 1993, less than six weeks after the break-up of the Czechoslovakian Federation.

Macroeconomic and political stability as well as liberalization of capital made the Czech currency attractive. After the large initial currency devaluation eroded in 1993, the real exchange rate of the Czech currency started to appreciate quickly, undermining national competitiveness and generating a large current account deficit.[522] Currency appreciation was primarily driven by higher domestic inflation given the stable foreign prices and massive inflows of foreign capital associated with the fast and extensive capital account liberalization in 1994–1995. Substantially higher interest rates against Germany (by two to three times), the main market for Czech exports, and the public commitment of the Czech monetary authorities to maintain the

[521] The monetary union was supposed to be retained for at least the first six months. A common monetary policy was to be determined by a special Monetary Committee. In addition, the custom union and the common labor market were intended to remain in place. However, low credibility and the lack of political commitment to the monetary union caused investors to fear the currency devaluation, which contributed to a substantial decline of foreign exchange reserves of the CNB to only U.S. dollar 0.5 billion in January 1993. Thus, the Czech government and the CNB thus decided on January 19, 1993 to separate the currency. After the dissolution of the monetary union, in March 1993, the Czech koruna was revalued by 2 percent and the Slovak koruna was devalued by 5 percent but they were revalued back again later (Firdrmuc, Horváth, and Fidrmuc 1999).

[522] There were additional factors contributing to the balance of trade deficits, including a high propensity to import, excessive wage growth, and increased competition in EE and Asia (Šmídková et al. 1998: 14–15).

currency peg encouraged strong inflows of foreign capital, reaching 17 percent of GDP in 1995 (Hallerberg and de Souza 2000: 22). Capital inflows encouraged by the high interest rate anti-inflationary policy led to a sharp appreciation of the Czech koruna's real exchange rate, appreciating by about 30–40 percent between 1992 and 1997 (Horváth 1999:285) (figure 7.2).



Source: Czech National Bank.

Figure 7.2: Nominal and real effective exchange rate, 1993–2001

The Czech Republic achieved a high degree of liberalization on its capital account early on. Foreign direct investments were liberalized in the early 1990s, although restrictions on foreign investments in the banking sector were maintained. The government applied a liberal approach to foreign credits in 1994–1995, as well. In general, the inflow of capital was liberalized more than its outflow (Árvai 2005; 9–10). While one of the often mentioned reasons for the accelerated capital account liberalization was the Organization for Cooperation and Development (OECD) accession, liberalization was clearly in the interest of the Czech banks, for

liberalization facilitated the banks' access to funds on international financial markets and brought them new profit-making opportunities.[523]

The fast inflow of short-term foreign capital in 1994–1996 was composed mainly of portfolio investments and foreign borrowing by the Czech banks and enterprises. Domestic banks played a particularly important role in channeling foreign debt finance into the economy and were among the largest foreign debtors. The foreign borrowing of domestic banks peaked at 6 percent of GDP at the end of 1995 and represented 40 percent of total foreign debt (Tůma 2006: 4).

Because the CNB built a high degree of credibility by successfully maintaining the exchange rate pegged within a narrow band, the banks were encouraged to borrow on international financial markets in foreign currencies to increase their resources and to profit from the lower foreign interest rates, while bearing no exchange rate risk. As a result, the banks accumulated a large negative position toward foreigners. Nonetheless, their foreign exchange balance sheet position was much lower because the banks were lending most of their foreign borrowing to domestic (often un-hedged) enterprises as foreign exchange loans.[524] Banks were borrowing in foreign currency, and they transferred the risk to domestic enterprises. Therefore, the banks transformed the foreign exchange risk into a credit risk. Because many of these foreign loans were granted to large enterprises in traditional industries, many of these enterprises experienced liquidity problems later. Clearly, the source of large financial inflows was

[523] The liberalization of foreign exchange transactions was completed by the adoption of a new Foreign Exchange Law that came into effect on October 1, 1995, just before the OECD accession, which took place in December 1995. Not only did the government exceed the OECD liberalization requirements, but the actual pace and extent of capital account of liberalization was also even greater than the official version (Holub and Tůma 2006).

[524] While the Czech banks accumulated a negative net position toward foreigners of 100 billion Czech koruna, their negative foreign exchange balance sheet position was only between 10-40 billion Czech koruna. Moreover, they tended to hedge this negative balance sheet position by off-balance sheet operations. As a result, their total open foreign exchange position was usually balanced or slightly positive in 1997. Therefore, in contrast to the Asian crisis, the Czech banking system did not experience a serious problem of currency mismatches (Holub and Tůma 2006: 16).

not the government or the monetary authorities but the domestic banks (Holub and Tůma 2006, Erbenova and Holub 2006, Begg 1998).

In the atmosphere of weak financial regulation, it was not only the big SOBs providing credit to state-owned enterprises without exerting oversight over management but also many small private banks practicing insider lending and providing doubtful loans to small enterprises (Horowitz and Petráš 2003). The soft credit policy of banks and disregard for the principles of prudential banking led to accumulating large inter-enterprise debt and nonperforming loans in both SOBs and small private domestic banks.[525] The Czech banks had double the bad loans of their Polish counterparts. Many of these loans were secured by newly privatized property. The lending portfolios that big SOBs inherited were heavily concentrated among a few enterprises or industrial sectors, so foreclosing on the biggest borrowers threatened the banks themselves.

The CNB, which has been the supervisory authority of the banking system since 1991, was not able to perform its responsibilities effectively in the beginning. Its Supervision Department was severely understaffed (with only eight employees in 1991) and lacked clear authority over the large SOBs; furthermore, the regulation of banks was primarily the responsibility of the Ministry of Finance (McDermott 2007: 233). The task of the CNB was further hampered by sharing government authority in the area of financial markets with the Ministry of Finance and other agencies (Neumann and Egan 1999: 184). The Ministry of Finance blocked CNB efforts to

[525] Inter-enterprise debt increased by 250 percent in 1991 and by 100 percent in 1992 (Rao and Hirsch 2003: 263). The exception was CSOB, which did not accumulate a large number of bad loans (8 percent share on classified loans) and did not receive any government aid after 1993. CSOB had several owners that mutually controlled each other: besides the Ministry of Finance, FNM and CNB, the EBRD and IFC co-owned the bank. As a result, the CSOB management was less responsive to government pressures for enterprise financing and was often criticized for failing to support the country's economic growth. Author's interview with Pavel Mertlík, former Minister of Finance (1999–2001) and Chief Economist of Raiffeisenbank, June 16, 2006, Prague.

impose a more stringent classification on non-performing loans on banks (Pazdernik quoted in McDermott 2007: 236). However, in 1996, the CNB managed to implement new regulations that increased disclosure of financial results, making it more difficult to roll over old loans and requiring a new, downward valuation of collateral (Nollen, Kudrna, and Pazdernik 2005: 371).

Still, the existence of large numbers of bad loans compelled the CNB to maintain high interest rate spreads between lending and borrowing rates to boost bank profits and thus their ability to build up their reserves. The limited bank competition, the small number of private competitors, and the market position of the major SOBs, allowed banks to pay out low interest rates on deposits and charge high interest rates for their loans to state-owned enterprises, and thus benefit from high interest rate spreads (around a 6 percent range) (Desai 1995). The creation of these "artificial" bank profits led to the emergence of small under-capitalized banks that continued to make risky loans (Brada and Kutan 1999: 6–7).

Since 1991, the government intervened on a massive scale to alleviate both inter-corporate and bank-held non-performing debts. It tried to solve the bad loan problem by placing the communist era trade loans with lower interest rates and longer durations in a new state-owned "hospital"–the Consolidation Bank (Konsolidační banka) (later the Consolidation Agency)–founded in February 1991.[526] Moreover, the government provided a one-time recapitalization of banks in 1991–1992 (McDermott 2007: 229). This way, the debt burden was shifted from the banks back to the taxpayers.

[526] The Consolidation Bank was proposed by Salzman, the Chairman of KB, who originally suggested only to transfer bad loans from the previous regime, the so-called TOZ; these were unsecured special purpose loans that originated during the pre-1989 era. However, banks started to transfer not only old but also new bad loans. Author's interview with Tomáš Ježek, Minister of Privatization of the Czech Republic (1990–1992) and President of the National Property Fund (1992–1994), June 20, 2006, Prague.

When the CNB Banking Supervision department observed, in 1993, the first signs that there were problems in small banks, it stopped granting new banking licenses and implemented two assistance programs for small banks, the Consolidation Program I (1991–1994) and Consolidation Program II (1995–1996), to clean up the balance sheets of banks and to prevent the overall destabilization of the banking system. During the period 1993–1996, several small and medium-sized banks collapsed, their licenses were revoked, and they were subsequently taken over by another bank.[527] A special case was Agrobanka, the sixth largest bank and the biggest private bank, which has been controlled by Motoinvest, an aggressive brokerage firm. To prevent the collapse of Agrobanka, the CNB ordered the Big Four banks to extend a large credit line to the bank, and later sold part of the bank to a foreign strategic investor (General Electric Capital Corporation), while CNB took over the part of the bank with negative value, increased the bank's capital, and provided bridge loans.

In October 1996, the government followed with the Stabilization Program, which involved acquiring bad quality receivables from the small domestic banks at their nominal value by Česká finanční (an agency established by the Consolidation Bank) up to a maximum of 100 percent of their capital (Mejstřík, Dvořáková and Neprašová 2004, Mervart 1998).[528] All of these programs were costly and had limited success: 22 percent of all banks loans were uncollectible and bad loans still accounted for 35 percent of all bank loans in 1996 (Newman and Egan 1999: 182).

[527] The first banks that collapsed were Kreditní a Prumyslová Banka, AB Banka, Banka Bohemia, and Česká banka. The Activities of COOP Banka, Velkomoravská banka, Ekoagrobanka, and Realitbanka were terminated through bankruptcy or liquidation. The CNB revoked the banking licenses of První Slezská Banka and Kreditní banka Plzeň. In addition, the Ministry of Finance had withdrawn licenses from 18 investment funds and fined 62 funds and enterprises.

[528] In fact, only six banks expressed an interest in joining this program because they were obliged to comply with the CNB prudential regulations. At the end only Expandia banka, purchased by the Czech Insurance Company, remained in the program (Mejstřík, Dvořáková and Neprašová 2004: 48-50).

The excessive foreign debt and reckless lending of incumbent banks not only exacerbated credit risk but also led to inflationary pressures. CNB reacted by imposing monetary restrictions and engaging in massive sterilization to prevent excessive real exchange appreciation associated with the risk of currency devaluation. These measures were not efficient because they were accompanied by a non-cooperative fiscal government policy, which became more expansionary over time. Therefore, the CNB decided to widen the exchange rate band to plus or minus 7.5 percent on February 27, 1996. While much debate and calls for a more flexible regime had already started in 1994, the extent of the band widening and the timing of the announcement prior to parliamentary elections in May 1996, introduced the intended insecurity for the investors and led to one-off outflow of short-term speculative capital.[529] The depreciation of the koruna was beneficiary for the Czech exporters who tried to capitalize on the currency by selling of foreign exchange (Jílek and Jílková 1998: 72–73). The CNB simultaneously tightened monetary policy by raising interest rates and intervening vigorously to avoid currency devaluation.[530]

Nonetheless, the attempts of the CNB to sterilize capital inflows were not very successful mostly because of the co-called "sterilization game" played by banks (Christensen 2004). The high-yielding sterilization bonds issued by the CNB and a credible fixed exchange rate system allowed the banks to borrow cheaply abroad and to invest in domestic bonds. Banks increased their foreign liabilities by 35 percent in the first half of 1995 and by 37 percent in the second half of 1995. Given large interest differentials and relatively free capital movements, sterilization policies attracted

[529] Author's interview with Miroslav Hrnčíř, Advisor to the Governor of the CNB, former member of the CNB Board, June 7, 2006, Prague.

[530] CNB imposed limits on the banks' short-term positions toward foreigners, raised interest rates by one percent, and the minimum reserve requirements (a tax on banks) by 3 percent.

additional short-term capital from abroad. The banks made a significant profit from these short-term capital speculations, and they were directly impeding the CNB from playing a guardian role for the national currency.[531]

Banks had two principal motives for foreign borrowing: speculative motives to exploit profitable investment opportunities as well as an interest in supplying credit to their clients, enterprises they controlled or in which they held shares (Christensen 2004). The large Czech banks made loans in their efforts to consolidate those Czech enterprises that could compete with the dominant European players in the traditional tradable sectors such as heavy engineering, transport equipment, and chemicals (Horowitz 2001: 226, Koleva and Vincensini 2002).The appreciating domestic currency was hurting Czech exports, and made them uncompetitive on world markets.

Towards the end of 1996 and in spring 1997, in the atmosphere of slow economic growth, rising current accounts and fiscal deficits, tensions inside the ruling coalition, but primarily between the government and the central bank, began to intensify. The personal tensions between Prime Minister Klaus and Tošovský, the governor of CNB, were already apparent in the initial years of transition. Tošovský was committed to building the credibility of the CNB, a goal that was incompatible with Klaus's vision of the central bank supporting the objectives of economic reform through the Czech banks.[532] Klaus, himself a former banker with 16 years experience with the same bank was a supporter of the banking sector and connected lending and was not willing to sacrifice the interests of banks. In return, bankers enabled his party to win re-election in May 1992 (Rutland 2001: 251).

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[531] This paragraph came from Christensten (2004).

[532] Author's interview with Ivan Kočárník, former Minister of Finance (1992–1997), June 14, 2006, Prague.

The conflicts between the central bank and the government became especially intense as the CNB moved to a restrictive stance in 1996 via increasing minimum reserve requirements imposed on banks. Klaus (2000: 13–14) blamed the CNB's anti-inflationary monetary policy of high interest rates and minimum reserve requirements for slow growth and banking problems, and he blamed the CNB indirectly for financial turmoil:

> Our commercial banks, relatively weak and ill-equipped with capital, being … at the edge of their possibilities, were hit by these monetary restrictions to a greater extent than our central bank expected or realized afterwards. I would like to argue that right then we embarked on the financial crisis.[533]

Klaus also blamed the CNB for prematurely opening capital accounts and for its unwillingness to move to a more flexible currency regime voluntarily before the currency attack.[534] Nonetheless, many observed that Klaus considered the long-sustained "hard" *koruna* policy as a source of national pride and a symbol of the successful transformation policies of the ODS-led government.[535] Inspired by the Austrian example, the government was overly optimistic about the resilience of the Czech banking system and the sustainability of the peg. The Austrian model, however,

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[533] Similarly, in his response to a fax from Stanley Fisher, acting managing director of the IMF at that time, Klaus characterized the anti-inflationary measures of the CNB in the following way: "The central bank made a totally irrational maneuver that can be characterized as overkill, if I can use a nice term" (Dyba 2000: 37).

[534] "This premature opening of the financial account, which I was personally quite afraid of, was, besides the prestige considerations, motivated above all by the CNB's efforts to reduce the sterilization costs associated with the speculative capital inflows, but this effect was surely not achieved. On contrary, the doors were opened for speculative capital flows in both directions" (Klaus 2000: 12).

[535] Author's interview with Oldřich Dědek, Professor of Economics at Charles University, former Advisor to the Prime Minister of the Czech Republic, former Vice-Governor of the CNB (1999-2005), June 12 and 10, 2006, Prague; author's interview with Ivan Kočárník, former Minister of Finance (1992–1997), June 14, 2006, Prague.

has proved to be inappropriate, for its financial system was more developed than the Czech one.[536]

It is clear that the incumbent banks negatively affected the ability of the government and the CNB to sustain a currency peg through channelling short-term capital flows into the economy, speculating with central bank's sterilization bonds as well as by engaging in inflationary politicized lending to connected parties that resulted in massive appreciation of the currency, enterprise insolvencies, and financial instability. Banks were pushing for monetary ease and expressed concerns about the adverse impact of the restrictive monetary policy of the CNB on the financial situation of their debtors, and their ability to repay existing debt (Geršl 2006). Due to their growing problems with bad loans, banks may have also had interest in maintaining the currency peg.[537] Still, the representatives of financial institutions, who were potential players against the koruna and could profit from its devaluation, predicted the fall of the Czech currency and recommended its devaluation from the beginning of 1997 (Šmídková et al.1998, Horváth 1999). The rent-seeking behaviour of banks was one of the most important triggers of a speculative run on the currency.

Political instability caused uncertainty on the international markets and a fall in confidence in the Czech government. The worsened economic situation prompted the Klaus government to issue two small packages of economic reform measures aiming at reducing budgetary spending, ameliorating the regulation of the banking sector, and

[536] Author's interview with Miroslav Hrnčíř, Advisor to the Governor of the CNB and former Member of the CNB Board, June 7, 2006.

[537] Author's interview with Pavel Mertlík, former Minister of Finance (1999–2001) and Chief Economist of Raiffeisenbank, June 16, 2006, Prague.

introducing import restrictions in April 1997.[538] But the government package to tighten fiscal policy and allow correction for the fiscal-monetary mismatch came late.

The first speculative attack on the fixed exchange rate of the Czech koruna came soon after on May 15, 1997. At the beginning of the crisis, the CNB tried to resist the speculative attack and defend the currency peg by massive interventions, several interest rate hikes, and administrative measures (domestic commercial banks were not allowed to make loans to foreigners in domestic currency) to prevent the koruna from depreciating.[539] The CNB administered a credit squeeze in defense of exchange rate parity in spite of the fact that the move posed a risk for domestic banks, representing a channel that impinged on macroeconomic policy. These measures proved to be insufficient given bad economic fundamentals and the growing inevitability that Klaus's government was going to collapse.

[538] The rising trade and current account deficits led to a shift in trade policy towards greater protectionism of domestic exporters in the second half of the 1990s. In 1995, the government established the Czech Export Bank to provide export financing to Czech enterprises. The Export Guarantee and Insurance Corporation became more active. In spring 1997, the government introduced an import deposit applying to 30 percent of all imports, followed by an anti-dumping law adopted in June 1997, and preferential treatment of domestic suppliers in public procurement (Erbenová and Holub 2006: 12).

[539] Interest rates were drastically increased: the 3-month PRIBOR interest rates got to 35 percent, and the Lombard rate rose from 14 to 50 percent. Repo rates rose to 75 percent and central bank marginal overnight lending rate increased to almost 200 percent on May 22, 1997 (Kutan and Brada 1998: 8, Horváth 1999: 288).

The situation sharply escalated when the population, losing faith in the koruna, started massively converting large amounts of koruna into foreign currency, causing a further sharp decline in the CNB's foreign exchange reserves (Šmídková et al. 1998).[540] On May 27, 1997, in spite of the risk of provoking banking crisis, the CNB and the government had already decided to devalue the currency by 10 percent, to abandon a currency peg, and to adopt a managed float with the Deutsche mark as the reference currency.[541] The central bank lost 2 billion U.S. dollars of foreign exchange reserves during the entire episode, which lasted less than two weeks (table 7.6).[542]

Inflation Targeting and Financial Liberalization

On December 22, 1997, the CNB announced a new inflation targeting monetary policy, combined with a flexible regime (table 7.7).[543] The CNB Board decided independently to switch to inflation targeting and only then informed the collapsing Klaus government, publicly announcing this policy change at the end of December 1997.[544] Klaus criticized inflation targeting as inappropriate for a

[540] Some Czech commentators argue that the timing of the financial turbulence in the Czech Republic was influenced by the contagion from the foreign exchange crisis in Asia since the speculative attack on the Thai baht had taken place only a few days earlier. However, as Begg (1998: 687-688) argues, the Czech koruna was not the "innocent victim of speculative frenzy."

[541] Some argue that the CNB was able to keep the currency inside the official band and defend the peg but chose to abandon it (Horváth 1999: 288).

[542] For excellent accounts of the 1997 financial turbulences in the Czech Republic, see Dědek (2000), Šmídková et al. (1998), Begg (1998), and Horváth (1999).

[543] The Czech Republic was the pioneer of direct inflation targeting in the EE region, following the examples of Finland, Sweden, and the United Kingdom (and to some extent Spain) that implemented this monetary strategy after the 1992–1993 crisis of the Exchange Rate Mechanism. Author's interview with Miroslav Hrnčíř, Advisor to the Governor of the CNB and former member of the Board of CNB, June 7, 2006.

[544] Author's interview with Milena Horčicová, Director of the Department for Financial Policies, Ministry of Finance, June 15, 2006, Prague.

Table 7.6: Chronology of the Czech Currency Turmoil in 1997

Dates	Events
February 11	Early warning signs: Czech koruna reaches its high above the central parity.
March 12	Prime Minister Klaus criticizes the monetary policy of the CNB as restrictive.
March 25	Prime Minister Klaus rules out devaluation.
April 17	Government approves a stabilization package, which strengthens the koruna. Prime Minister Klaus urges a loosening of monetary policy again.
May 14	Koruna at its low, 3.88% in the devaluation band. Financial Times publishes a negative survey for the Czech republic. Opinion poll shows Prime Minister Klaus' ruling party popularity at all-time low.
May 15	Koruna fell sharply within the band to 5.25% below its central parity. CNB engages in unsterilized intervention, reflected in reserve losses and high interest rates.
May 16	CNB raises the repo rate from 12.4% to 12.9% and the Lombard rate from 14% to 50% with restrictions on access to the Lombard window.
May 20	KB (the largest Czech commercial bank) increases its prime lending rate to 24.7%. Other banks follow. CNB limits access to the Lombard window. Overnight inter-bank rates rise to almost 100%.
May 22	Koruna comes under renewed pressure, depreciates to 6.2% below parity and then recovers to 3–4% below parity. Overnight interest rates reach almost 200%. Public confidence weakens and residents start to exchange koruna into foreign currencies.
May 26	The CNB Governor in a joint press conference with Prime Minister announces that the ±7.5% target band will be replaced by managed float and that koruna will be stabilized vis-à-vis DEM but without officially binding limits.

Source: Horváth (1999), Begg (1998).

transitioning country and warned that low inflation targets would lead to economically costly disinflation policy (Klaus 2000: 20).[545] The banking sector did not have time to react to the choice of this new monetary policy framework.[546] CNB's main motivation to adopt this inflation strategy, as its main proponents, Šmídková and Hrnčíř (2003: 13) argue, was to increase the independence of CNB further:

> A change to inflation targeting has an effect analogous to increasing the independence of central bank since it moves the central bank to the centre of economic discussions. In this sense, formal independence of central bank is fully realized. Specifically, the CNB announced inflation targets according to its own assessment…

Table 7.7: Evolution of Inflation Targeting

Direct Inflation Targeting (DIT) adoption date	January 1998
Type of DIT	Initial: strict; Present: flexible
Intermediate target level	Initial year: 5.5–6.5% (December 1998); Present: 3.0% ±1% band
Actual realization	Initial year: 1.7% net, 6.8% CPI; Present: 4%
Corresponding exchange rate regime	Initial: managed float; Present: managed float
Target announcements	CNB Board

Source: Adapted from Orlowski (2008: 445–446)

[545] The speed of disinflation caused a conflict between the government and the CNB, given the negative growth of GDP between 1997 and 1999 and low inflation in 1999, accompanied by discussions about limiting CNB independence in 1999 and 2000 (Geršl 2006: 18).

[546] There was some initial opposition to inflation targeting from within the CNB, particularly from its monetary policy section. Critics were however, unable to present convincing arguments. Author's interview with Vít Bárta, Advisor to the Vice-Governor of CNB, June 9 and 13, 2006, Prague.

The Klaus government was forced from power in late 1997 by the financial turmoil and a campaign finance scandal. As Vachudova (2001: 343) noted: "It emerged that money had flowed into the ODS and also the ODA party coffers in exchange for favors related to privatization and banking." The ODS-led government was dissolved by the president who appointed a new caretaker government in January 1998 on professional merits rather than political affiliation. Led by the former central bank governor Tošovský, this new government introduced financial sector reforms including the opening of the Czech banking sector to foreign banks and a stricter regulation of investment funds and banks. For example, the new law on banks adopted in 1998 prohibited banks from acquiring shares in industrial enterprises.[547]

After the early Parliamentary elections of June 1998, a minority Social-Democratic government led by Prime Minister Miloš Zeman assumed the responsibility for a large number of bad loans, and then sold the sanitized financial institutions to foreign strategic investors.[548] Originally, the Zeman government wanted the banks to resolve their problems themselves. Its finance minister, Pavel Mertlík, however, pushed through privatizing big Czech banks to international investors and fought demands to pump government money into failing industrial conglomerates (Andrews 2001).[549] When a recession ensued and the banks experienced solvency problems, the government decided to privatize them. The Social Democratic government not only privatized the largest banks but also regulated financial markets

[547] See Resolution No. 732 of November 19, 1997.

[548] The Social-Democratic government of 1998–2002 was a single party minority government. While the Social Democrats occupied all of the ministerial posts, they only controlled 74 of 200 seats in the parliament. CSSD signed what came to be known as the "opposition agreement" with the ODS, the second largest party in the parliament. The agreement declared that ODS would allow CSSD to govern alone as a minority government (Roberts 2003).

[549] Mertlík resigned in 2001 because he ran into increased opposition with some members of the coalition government led by Miloš Zeman, particulary Miroslav Grégr who has pushed for big new government spending to shore up Czech industry.

and actively promoted foreign investment through tax advantages and subsidies. The government sold a 65 percent stake in CSOB to Belgium KBC Bank in the spring of 1999 and a 52 percent stake in CS to Austrian Erste Bank in the summer of 2000. Finally, in the summer of 2001, the government privatized KB to Societé Génerale. The share of foreign bank assets represented over 90 percent by 2001.[550]

The privatization of IPB, the third largest Czech bank, might appear to be inconsistent with the argument made in this study because its foreign ownership was not enough to discipline the bank's behavior. The Czech government approved the plan to privatize IPB by selling the state's 46 percent share to Nomura Europe, a foreign investor, in March 1998. The Social-Democratic government did not assume bad loans prior to sale, nor did it provide any guarantees to the buyer. After the sale, the bank's asset quality deteriorated further. The bank provided misleading information about its true financial situation to the CNB banking supervisors, and concealed it by recording assets at overstated values, removing bad debts from its books, and selling bad assets to related parties. In June 2000, there was a run on the bank, which led to forced administration by the CNB. In the meantime, Nomura had sold some of IPB's stronger industrial assets and realized high profits.[551] Faced with the alternative of closing the bank, the government quickly sold IPB to CSOB, owned by the Belgian bank KBC. The costs of IPB losses were high and the sale entailed cleaning the bank's balance sheet and getting the state's guarantees on deposits and on

[550] For the chronology of the post-1997 privatization of the major Czech SOBs, see Havel (2004).
[551] IPB sold its beer holdings, including the world-renowned Pilsner Urquell. Nomura bought them, pooled the stake with its own Czech beer assets, and then sold them to South African Breweries PLC and realized as much as 300 million U.S. dollars profit (Karnitschnig, with Lesenarova 2000).

the quality of assets for a certain period after the sale.[552] The forced takeover of IPB has been one of the costliest and the most controversial bank failures in EE.[553]

Although foreign investment did not prevent the rent-seeking of the IPB management and the failure of the bank, this study's analytical framework can still be useful for understanding this case. First and foremost, in contrast with the hypothesis made in this study, Nomura did not consider the IPB acquisition as that of a *strategic* investor but rather as a portfolio investor. Nomura bought the Czech bank for its equity shareholdings and not for its banking business. The IPB shares were held by Saluka Investments, a Dutch-based special purpose vehicle. Therefore, Nomura did not engage in bank restructuring, and it resisted the pressures of the CNB and the government to recapitalize the bank when the crisis began to loom. Second, while this study examines the interests and behavior of conventional commercial banks, Nomura is an investment bank; for instance, it is barred by law from banking in Japan. It lacked the expertise to transform IPB's commercial banking activities. Finally, Nomura, a minority holder of the IPB, did not have control over the bank's lending decisions, which the incumbent management kept firmly in its hands, so Nomura did not exercise real control of the bank management and did not properly supervise their local representatives. Voucher privatization led to an increase in incumbent bank management's influence, which was further strengthened in 1993–1994 when the state failed to participate in purchases from a new share issue (Čulík 2000). The bank managers won control from the state by using subsidiaries and investment funds to

[552] For a history of IPB's privatization, see Kudrna et al. (2002), Wagner and Iakova (2001), Kočenda (1999). This author also actively participated in the post-privatization debates concerning IPB during her assignment at the DG Competition, European Commission, Brussels in 2004.

[553] Nomura Securities of Japan pursued a legal dispute and the international arbitration tribunal ruling that the Czech government failed to accord Nomura fair and equitable treatment. For its part, Nomura faces serious allegations over its behavior at IPB launched by the government and by CSOB, IPB's new owner.

buy IPB shares. By the mid-1990s, IPB became the country's dominant financial group with the most opaque ownership structure in the Czech Republic. The bank was heavily connected politically with the Klaus ODS and was one of its leading sponsors.[554]

Conclusion

The history of exchange rate politics in the Czech Republic demonstrates how a small distributional coalition formed by the financial elite colluded with the government and various enterprises. This coalition became the main beneficiary of the monetary, regulatory, and exchange rate policies by taking over divested assets and bringing a country to financial instability. The reform measures introduced by Czechoslovakia in 1991 were a slightly moderate form of shock therapy compared with the Polish ones. In spite of the declarations of the Klaus government about the state's radical withdrawal from the economy, there was inconsistency between the government's liberal rhetoric and its continuous interference with the economy. The reform approach of the ODS-led governments aimed at promoting a domestic class of entrepreneurs through the voucher method of divestiture of state assets in banks and industries and political pressures on SOBs to lend to financially distressed enterprises. One of the most important outcomes was a reproduction of the financial hegemony of banks in the economy, which with bank-sponsored IPFs became new sources of power. The Czech voucher privatization plan effectively prevented the entry of foreign strategic investors and foreign ownership in the Czech banking systems, so the voucher method did not cut the links between the state and incumbent financial and industrial interests.

[554] The closeness of the links illustrates the fact that Klaus's chief adviser was on IPB's supervisory board (Anderson 2006).

It was argued that the voucher scheme had been inspired by an Anglo-Saxon model of "popular capitalism," but instead it resulted in a system of cross-holding and bank-industry ties that was closer to a German model of capitalism. In contrast to the German banks, however, the Czech banks did not shape the enterprises' investment decisions or force their restructuring. Nor did it build long-term relationships with the enterprise they controlled through IPFs (Neumann and Egan 1999).

The government involvement in the banks generated incentives for moral hazard in the financial sector. The government refrained from imposing strict banking regulation and provided guarantees for bad loans in return for the banks' support of industries and employment, thus guaranteeing popular support. The government induced additional moral hazards by credibly committing to the currency peg and to using foreign exchange reserves to bail out banks with liquidity problems. These actions encouraged banks to discount the risk of default and to repeat imprudent lending practices and short-term capital speculations that eventually resulted in the 1997 financial turmoil.

The successive Klaus center-right governments were committed to certain ideologies and policies, often conflicting with that of the central bank, which made it difficult for them to correct mistakes. Incumbent banks and industries, which were the beneficiaries of successive right-wing governments before the crisis, tried to preserve their advantages and prevent opening the domestic banking sector to foreign buyouts because of a fear of competition that would reduce their positional rents. Maintaining ODS dominance in Czech politics thus came to depend on the support of incumbent financiers. Only the economic crisis helped to break the ODS monopoly and allowed re-evaluating the role of the banks.

The Czech case also demonstrates that central bank independence is not a sufficient condition for a sustainable currency regime if a domestic financial system

retains its clientelistic features. The CNB has been an internationally praised central bank with a high degree of independence from the government in monetary policy. Although the Klaus government repeatedly criticized the policies of CNB policies, it did not seek to formally limit central bank independence. Because the CNB has been independent, it has focused on disinflation rather than targeting domestic monetary policy toward exchange rate. The monetary authority of the CNB, however, did not match the quality of its regulatory oversight, particularly in the initial stages of reform.

The competing arguments based on the role of OCA factors, macroeconomic fundamentals, sectoral interests, and international factors are not supported by Czech exchange rate history. First, there is a little evidence that OCA arguments played a role in the exchange rate regime choices.[555] Second, no general deterioration of the macroeconomic fundamentals, traditionally associated with currency crises, was present during the Czech crisis as it was in Bulgaria. Inflation was relatively low, the central bank accumulated sufficient foreign reserves because of large capital inflows, and while its fiscal stance deteriorated, it was not excessive. Moreover, favorable historical legacies of macroeconomic and currency stability during the interwar and communist periods did not necessitate the adoption of a fixed exchange rate as a nominal anchor at the outset of the transition. These legacies appear to be inadequate in explaining banking instability, financial turmoil, and the collapse of the currency peg in 1997. Third, the sectoral argument that large tradable manufacturers have incentives to lobby for competitive, depreciated exchange rates is not compelling, either. Large Czech enterprises in heavy industries were in a weak position and lacked well developed means of organizing and lobbying the government. But the top management positions at the big SOBs were held by the appointees from the Klaus ODS and other center-right governmental parties, so it was more advantageous for

[555] Author's interview with Zdeněk Tůma, Governor of the CNB, June 15, 2006, Prague.

enterprises to lobby bank managers that had close links with the ODS-led governments (Horowitz and Petráš 2003: 255–256).[556]

Finally, the role of the IMF in Czechoslovakia and its successor state, the Czech Republic, in the design of the stabilization program and the exchange rate policy has been limited, for the government introduced many program elements before signing the standby agreements. In addition, the Czech government decided against the last drawings of the standby arrangements and started to repay its debt earlier than contractually agreed (Drábek 1995).[557] In general, Klaus was notoriously known for his negative attitude toward foreign advisers and international institutions,[558] claiming that they were of no use because of the uniqueness of the reform process in individual countries.[559] The Klaus ODS also regularly criticized the EU for imposing excessive infringements on national sovereignty; instead Klaus promoted nationalist policies and anti-foreign investment sentiment (Roberts 2003: 1994, Petrovic and Solingen 2005.

[556] Exporters, facing appreciated national currency, started to pressure the CNB for easing the monetary conditions (the combination of interest rates and the exchange rate) more recently. But the CNB did not succumb to these pressures (Geršl 2006). Some industrial sectors emerged over time as well-organized and powerful players in the distributional struggles of transition, including the steel industry represented by the Iron and Steel Federation and the Automotive Industry Association of car manufacturers (Orenstein and Desai 1997).

[557] The IMF concluded two stand-by agreements with the Czechoslovak government and one with the Czech government. The first stand-by of December 18, 1990 represented a 14-month arrangement in the amount of SDR 620 million including SDR 148 million with a contingency loan for oil purchases and the so-called Compensatory and Contingency Financing Facility in the amount of SDR 439 million to compensate for the rising costs of oil imports. The second agreement of March 2, 1992 was SDR 236 million. The third standby of March 1, 1993 amounted to SDR 177 million, but the Czech government decided not to draw the two tranches of this loan (Drábek 1995: 236).

[558] Klaus accused international financial institutions of concentrating on "catalyzing loans for big multinationals," which tend to invest in the Czech Republic (Klaus 1997: 144).

[559] Klaus has focused his recent criticism on the U.S. economist Joseph Stiglitz, claiming that "...the advice given by Joseph Stiglitz—that we should have made our transformation as gradual as the Chinese have done—is laughable" (Klaus 2006).

CHAPTER 8

POLAND: CONSENSUS

The final case is the history of exchange rate policy in Poland. This case aids our exploration of the extent to which the ownership structure and institutional features of a financial system correspond to choices and sustainability of an exchange rate regime. Moreover, the financial system itself is a function of the method of divestiture of state assets and openness to foreign investments in the banking sector. The history of Polish exchange rate policymaking is punctuated by four turning points in 1990, 1991, 1995, and 2000. The presence of strong organized opposition gave assurance that the Polish reform team had unchallenged control right at the outset of the post-communist transition. These conditions enabled the team in 1990 to implement the big bang reform program, based primarily on a fixed exchange rate as a nominal anchor. The two subsequent realignments in 1991 and 1995 were associated with the adoption of less rigid fixed regimes. The Polish central bank abandoned a hard peg after the first sixteen months of the transition and pursued various soft pegs until 2000, at which point it adopted a combination of inflation targeting and regime flexibility.

There is no question that the preference for the involvement of foreign investors in bank and enterprise privatization and restructuring was driven by the first Polish post-communist government's intention to use outsiders, excluding the possibility that incumbent business and financial interests might become powerful lobbies for influencing economic policies. Poland took a positive stance toward foreign competition in the financial sector from the outset of the transition but then backtracked temporarily before again opening the banking sector to foreign buyouts.

Privatization was carried out gradually and consistently, on a case-by-case basis, by actively involved foreign investors.

Banking reform resulted in a successful open financial system, based on a "consensus" among the government, the central bank, financiers and industrialists in monetary, regulatory, and exchange rate policies. The Polish case demonstrates how this type of financial system enabled the government to sustain a fixed exchange rate regime and adjust it to the competitive needs of domestic industries while avoiding financial crisis. It is remarkable that the Polish economy also managed to resist a currency attack in the wake of the 1998 financial crisis in Russia, which was Poland's third largest trading partner.[560] Having the smallest decline in output among post-communist countries and being the first to return to economic growth, Poland became a symbol of transitional success.

In contrast to the Czech Republic, a radical stabilization program was required in Poland at the beginning of the transition, for the country's socialist legacies presented serious economic problems. The unsuccessful attempts of the communist government in Poland between 1982 and 1988 to liberalize and reform the economic system resulted in deep macroeconomic imbalances coupled with economic stagnation. The communists increased enterprise autonomy, which allowed for strong wage growth. Furthermore, pursuing a loose credit policy further softened the already flexible budget constraints. Finally, the monetary authorities pursued an accommodating monetary policy involving automatic (interest-free) financing of the budget deficit by the central bank. All of these policies led to inflationary pressures, so by mid-1989, the last communist government lost control over the economy.

[560] Polish exports were down 74 percent in 1998 (Huterski, Nicholls, and Wisniewski 2004: 198).

As a result, in 1989, Poland was plagued by hyperinflation (which stood at 3,000 percent in the last five months of 1989), shortages, a large budget deficit, and unserviceable external debt (Gomulka 1995: 323).[561] The Polish communist leadership used external loans and credits obtained during the 1970s to finance consumption and to support the military efforts of the Soviet bloc; furthermore, the government stopped servicing its foreign debt in 1981 (Kochanowicz, Kozarzewski, and Woodward 2005: 38, Polanski 1994: 3–4, Kaminski 2001: 314).[562] On the positive side, the communist governments' steps toward liberalization resulted in a private sector, whose output was already nearly 19 percent at the beginning of the transition (Schwartz 2006: 34).

This chapter is structured much like the chapters on Estonia, Bulgaria, and the Czech Republic. It starts with an analysis of the initial reform framework that surrounded the fixed exchange rate regime. The section that follows establishes the elements of the finance-based theory by examining macroeconomic stabilization, privatization, and banking reforms and their influence on bank behavior. Finally, as the story of government policy unfolds, the chapter shows how a policy of financial openness enabled the government and a cooperative central bank to conduct a consensual exchange rate policy that promoted national competitiveness.

The Balcerowicz Plan

The collapse of the communist regime in Poland was "pacted": it started in the early months of 1989 with Roundtable Negotiations on power sharing between the Solidarity opposition movement and the communist leaders. The presence of an organized opposition to communism at the moment of regime change that was strong

[561] The gross foreign debt vis-à-vis Western countries reached nearly 41 billion U.S. dollars in 1989, representing 58 percent of GDP.

[562] For a detailed examination of the origins of high inflation in Poland in the period from 1980 through 1989, see Polanski (1991).

enough to take power had a profound institutional effect: the leaders of the pre-1989 opposition were in a position to frame the emerging political debate. Communists were aware that a Polish population that demanded change would only accept much needed economic reforms promoted by a Solidarity-endorsed government (Vachudova 2005). The landslide victory of Solidarity in partially free elections in June 1989 marked the start of economic and political reforms in Poland.[563]

The accommodative communist regime in Poland allowed strong and well-organized economic interests to form, such as farmers' associations and political Solidarity factions (Kitschelt et al. 1999). Poland inherited an industrial structure characterized by heavy, geographically concentrated state-owned industries and underdeveloped consumer industries and services representing strong and concentrated lobbies. Many of these state-owned industrial enterprises were large. They had many employees and a monopolistic position on the domestic market, so they benefited from great bargaining power. A negotiated exit mode from communism also provided an opportunity for these potential rent-seekers to entrench themselves. Contrary to expectations, though, these societal and economic interests have not been able to "politicize" the state (Grzymala-Busse 2002). The bargaining power of the communist (political and economic) elite disappeared by the end of 1989 and the opposition leaders were able to frame the reform debate.

The first Solidarity-led government that emerged in September 1989 inherited a command of an economy hovering on the verge of hyperinflation. Prime Minister Tadeusz Mazowiecki and his team of technocrats led by the finance minister Leszek Balcerowicz launched a radical anti-inflationary strategy known as a "shock therapy"

[563] Solidarity candidates won 35 percent of the seats in the lower legislative chamber that they had been allowed to contest and all but one of the 100 seats in the upper house. They also won the political support of the previously subservient auxiliary parties that were part of the political establishment during the communist period (Lewis 1998: 27-28).

program of economic transformation, published in "The Government's Memorandum on Economic Policy," on January 1, 1990.[564] The reform program was an expression of the government's willingness to cut its ties with the past. As shown in chapter 7, strong parallels to the program were also visible in the Czechoslovak program and in several other post-communist states.

Balcerowicz (1995), the architect of this initial radical reform program (also known as the "Balcerowicz Plan") maintained that the initial transition period, to which he has referred to as the "period of extraordinary politics," provided a window of opportunity for policymakers to push for decisive reforms because "major discontinuities, i.e. liberalization from external dependence and political liberalization produce a special state of mass psychology and a corresponding state of political system," resulting in an unusually high level of acceptance of radical reform measures. At the time that the Polish economic reforms were introduced, the communist status quo has been destroyed and no established interests were in place to endanger it, which dictated the rapid pace of preparations to launch the Balcerowicz plan. This stabilization plan prepared by Balcerowicz' economic team quickly gained political support of the government and the Parliament.[565] There was no public discussion

[564] When Mazowiecki became Prime Minister, he was searching for a "Polish Erhard," which refers to Ludwig Erhard, the author of West Germany's "economic miracle." Balcerowicz was found to fill this role. In fact, the choice of Balcerowicz as the finance minister in the Solidarity government was a surprise because he was an outsider, unknown in the main political circles. It was Waldemar Kuczynski, the chief advisor of Mazowiecki, who "invented" Balcerowicz and launched his extraordinary political career. Author's interview with Waldemar Kuczynski, former Chief Economic Advisor of Mazowiecki, Minister of Privatization and Chief Economic Advisor of Jerzy Buzek (1997–2001), July 17, 2006, Warsaw; author's interview with Andrzej Topinski, former Vice-Governor of NBP (1989–1992), President of the Polish Bank Association, July 14, 2006, Warsaw. Also see Kuczynski (1992: 45-62).

[565] The "Balcerowicz Team" consisted of Marek Dabrowski, later Deputy Minister of Finance; Stefan Kawalec, chief Advisor, responsible for financial institutions; Grzegorz Wojtowicz, first Deputy President of the central bank; and Janush Sawicki, responsible for foreign debt negotiations. All were graduates of the Faculty of Foreign Trade of the Central School of Planning and Statistics in Warsaw. The group also included foreign advisers (Jeffrey Sachs, David Lipton), foreign advisers of Polish origin, the so-called Polonia academics (Stanislaw Gomulka, Jacek Rostowski, and Stanislaw Welisz) as well as Polish ones (Andrzej Bratkowski, Karol Lutkowski, Adam Lipowski) (Hunter and Ryan 2008).

concerning the initial economic reforms,[566] and this allowed the government to operate under conditions of minimal political friction, albeit for only a few months (Kaminski 2001: 323).[567]

The main elements of the Balcerowicz liberalization and stabilization program included a restrictive monetary policy; the removal of virtually all price controls (price liberalization had already begun under the communist regime); tight fiscal discipline and elimination of the budget deficit; the introduction of currency convertibility; a restrictive tax-based income policy accompanied by regulations promoting market structures in the banking sector, as well as property transformation. The Polish reformers believed from the outset that ownership changes are indispensable for the market mechanism to work properly. The radical liberalization of business activities started as early as 1988. Banking reforms, including far reaching liberalization of financial institutions, were instituted in 1988–1989 (Polanski 2002: 107).

Nonetheless, after only a year, political backlash against strict reforms occurred and the Mazowiecki government was replaced by another right-of-center Solidarity government led by Jan Krzysztof Bielecki (January–December 1991), one that promised to promote a "controlled liberalism" version of the transition. The subsequent government led by Jan Olszewski (December 1991–May 1992) also came to power by opposing shock therapy and favoring a reflationary agenda, low interest

[566] Author's interview with Jerzy Hausner, former Minister of Labor (2001–2003), Minister of State Treasury (2004) and Minister of Economy (2003–2005), July 6, 2006, Warsaw. Consensus within the government was facilitated by the fact that Balcerowicz was Deputy Prime Minister and he was thus able to nominate the entire economic policy team; its members were his close associates, except for the President of the central bank, Wladislaw Baka, who was appointed by Jaruzelski, the last communist president (Stone 2002: 93, fn. 8).

[567] The presidential election in 1990 completed the fragmentation process of the Solidarity elite between the dissident intelligentsia led by Prime Minister Tadeusz Mazowiecki and those who supported Lech Walesa's traditional worker power base. Walesa, who won the presidential election in 1990, paid little attention to the parliament or the constitution in his efforts to build a strong presidency (Michta 1997, Kaminski 2001). However, in spite of his pre-election rhetoric, President Walesa supported the policies of Mazowiecki's government (Stone 2002: 95).

rates, and increased government aid to farmers and industries. However, both Bielecki's and Olszewski's governments failed to devise a transformation program that would differ markedly from the Balcerowicz plan. The next Solidarity cabinet of Hanna Suchocka (1992–1993) was also strongly committed to the continuation of a radical reform program (King and Sznajder 2006: 771, Slay 1993, Stone 2002) (table 8.1).

Fighting Hyperinflation and the Exchange Rate Anchor

One of the principal goals of the Polish reform program was to combat hyperinflation. As Balcerowicz put it: "Inflation was like a spreading inferno, which had to be quenched, or at least contained, in order to make it possible to change the economic system" (Balcerowicz quoted in Stone 2002: 91). Fear and doubt about ending hyperinflation, introducing currency convertibility and being able to pursue a market determined exchange in the absence of functioning foreign exchange markets brought a political consensus within the government about the need to peg the Polish zloty.[568]

While a quick political consensus concerning the choice of the initial exchange rate regime emerged, the political debate over where to peg the Polish currency was more complex and contentious. In January 1990, the exchange rate was fixed at 9,500 zloty per U.S. dollar after a 46 percent upfront devaluation.[569] Still, there were

[568] Author's interview with Marek Dabrowski, former First Deputy Minister of Finance (1989–1990), Member of Parliament (1991–1993), and Member of the Monetary Policy Council of the NBP (1998–2004), July 3, 2006, Warsaw.
[569] For the history of the Polish zloty, see Wojtowicz (2005).

Table 8.1: Governments in Poland, 1989–2003

Duration of Government	Prime Minister	Party Affiliation of Prime Minister	Political Orientation of President and Government
August 24, 1989–January 12, 1991	Tadeusz Mazowiecki	Democratic Union (Unia Demokratyczna, UD)	Same
January 12, 1991–December 5, 1991	Jan Krzysztof Bielecki	Liberal Democratic Congress (Kongres lieralno-Democratyczny, KLD)	Same
December 23, 1991–June 5, 1992	Jan Olszewski	Centre Alliance (Porozumenie Centrum, PC)	Same
July 11, 1992–April 27, 1993	Hana Suchocka	Democratic Union	Same
April 28, 1993–October 25, 1993	Hana Suchocka	Democratic Union	Same
October 26,1993–March 5,1995	Waldemar Pawlak	Polish Peasant Party (Polski Stronnictwo Ludowe, PSL)	Different
March 6,1995–February 6, 1996	Jozef Oleksy	Democratic Left Alliance (Sojuz Lewicy Demokraticznej, SLD)	Different
February 7, 1996–October 30, 1997	Wlodsimierz Cimoszewicz	Democratic Left Alliance	Same
October 31, 1997–June 6, 2000	Jerzy Buzek	Electoral Action Solidarity of the Right (Akcja Wyborcza Solidarnosc Prawicy, AWS)	Different
June 7, 2000–October 18, 2001	Jerzy Buzek	Electoral Action Solidarity of the Right	Different
October 19, 2001–February 28, 2003	Leszek Miller	Democratic Left Alliance	Same

alternative proposals, ranging from 5,000 to 28,000 zloty per U.S. dollar to promote exports.[570] The Ministry of Foreign Economic Relations, influenced by the export lobby, suggested deeper devaluation and pegging the zloty at a 14,000 level per U.S. dollar.[571] Others, however, warned that excessive devaluation would create additional inflationary pressures. At the end, the view prevailed on the introductory devaluation of the currency that considered exchange rate as a tool to stimulate exports and restrict imports, and thus the accumulation of foreign reserves.[572] On the other hand, the deliberate undervaluation of exchange rate was also intended to help the government to adhere to its commitment to a fixed regime (Wellisz 1997: 159).

Unlike Estonia or the Czech Republic, the Polish zloty was initially pegged to the U.S. dollar rather than the Deutsche mark because of the high level of dollarization that existed under the communist regime. Dollar accounts from Polish households were substantial, even bigger than the central bank's foreign exchange reserves. They were subsequently spent by the government to service its foreign debt.[573] Because of the country's large foreign debt and in order to design its reform program seriously, the Polish government had to abide by the opinions of the IMF, the World Bank, and

[570] Some even recalled the 1948 German reform, suggesting the possibility of eliminating inflation by exchanging money at rates that would depend on different forms of investment (Kowalski and Stawarska 1999: 356).

[571] Author's interview with Marek Dabrowski, former First Deputy Minister of Finance (1989–1990), Member of Parliament (1991–1993), and Member of the Monetary Policy Council of the NBP (1998–2004), July 3, 2006, Warsaw.

[572] One of the strong proponents of this view was Gomulka, a government advisor who considered a fixed exchange rate to be a tool to restore the country's external balance rather than a tool to fight inflation. Instead, monetary, fiscal, and income policies were intended to play the role of anti-inflationary tools (Gomulka 1995). Author's interview with Stanislaw Gomulka, former Advisor to Balcerowicz and Reader in Economics at the London School of Economics, July 13, 2006, Warsaw.

[573] Author's interview with Stanislaw Gomulka, former Advisor to Balcerowicz and Reader in Economics at the London School of Economics, July 13, 2006, Warsaw.

foreign advisors.[574] The government needed to obtain the support of the international financial community for the rescheduling and reduction of its foreign debt. It also needed to gain international credibility for its reforms and to secure new credits (Gomulka 1995: 320, Kaminski 2001: 312–5). Although the Polish stabilization program resembled a typical IMF package in its logic and basic assumptions, the Polish reformers maintained that it was locally owned, conceived, and designed by the Balcerowicz team and only later approved by the IMF. In fact, the Polish reform program was more ambitious than the reform steps suggested by the IMF. But "Poland has always been considered to be 'the best student in class,' … and in the end one of the few examples of success of the IMF" (Belka quoted in King and Sznajder 2006: 768). The Polish reformers used the constraints imposed by international financial institutions politically as an important argument to the domestic electorate to promote a radical reform program (Stone 2002: 92).

While there were some policy controversies in several important issue-areas between the two negotiating parties, they were usually resolved by international institutions that accepted the Polish view (Gomulka 1995). In the exchange rate policy area, the IMF strongly insisted during the December 1989 negotiations that, in order to break the inflationary expectations of the population, the exchange rate should be fixed for a period of 12 months, and the Polish government should make a public commitment to defend the exchange rate. The Polish side (represented by Balcerowicz and Gomulka) maintained that a mere public announcement by the government carries

[574] One of the key foreign advisors was Harvard economist Jeffrey Sachs, who advised the Solidarity group from the summer 1989. He has successfully convinced the Solidarity parliamentarians of the necessity to rapidly combat hyperinflation and advocated for a reduction of Polish debt on the international scene. In its October issue, the New York Times even referred to the Polish reform plan as "the Sachs Plan" (Kochanowicz, Kozarzewski, and Woodward 2005: 39-41, Kuczynski 1992). Also, author's interview with Grzegorz Kolodko, former Minister of Finance (1994–1997 and 2002–2003), July 2 and 5, 2006, Warsaw. For Sach's view on the Polish transition, see Sachs (1993).

little weight and the sustainability of the exchange rate will depend on the actual monetary, fiscal, and income policies. The Polish negotiators finally accepted that the fixed exchange rate should be maintained for at least three months as a policy objective, but no public announcement had been made about the duration of the arrangement.[575]

Adopting a limited-horizon of commitment to the fixed exchange rate policy was motivated by the need to "anchor" the national currency but at the same time by the desire to preserve room for re-adjustment in case the initial regime proves to be inappropriate (Wellisz 1997: 158). Because the level of international reserves was insufficient at the time the currency peg was introduced, in 1989, the Bank for International Settlements in Basel granted a loan of 215 million U.S. dollars as a reserve supplement. In addition, the G-24 governments created a 1 billion U.S. dollar Zloty Stabilization Fund to underpin confidence in the fixed exchange rate of the zloty.

The Solidarity reform measures that contained a policy of a fixed exchange rate regime brought a sharp reduction in inflation, from 1,096 percent prior to their implementation to 249 percent in 1990; 60 percent in 1991; 44 percent in 1992; and 38 percent in 1993 (Gomulka 1995: 323). Although the output dropped by 7.6 percent for 1991, it has been the most moderate and short lived drop compared with most other post-communist countries (Kochanowicz, Kozarzewski and Woodward 2005: 45). In fact, Poland was the first post-communist country that had already exceeded its pre-transition level by 1995.

The reform program also contained massive cuts in fiscal subsidies (enterprise and product subsidies declined in 1990 from 52 to 25 percent) and increased

[575] Author's interview with Stanislaw Gomulka, former Advisor to Balcerowicz and Reader in Economics at the London School of Economics, July 13, 2006, Warsaw.

competition from private enterprises and imports. Right from the beginning, the Polish authorities focused on creating a favorable environment for foreign direct investment. They eliminated most licensing requirements and allowed free repatriation of profit and invested capital, in addition to the ownership transformation. In contrast to the Czech reformers, one of the most important goals of the Polish reformers was to impose hard budget constraints on enterprises and the relations between enterprises and banks. The Balcerowicz plan assumed that the "hard" financing of enterprises and market competition would transform their mode of functioning somewhat like private enterprises even prior to privatization (Baltowski and Mickiewicz 2000: 426).

A Multi-Track Approach to Ownership Transformation

As argued above, the first Polish post-communist governments made developing the private sector a cornerstone of their economic reform policies. Privatization involving foreign investors was a crucial part of this process. A variety of privatization methods were proposed and discussed in 1989–1990.[576] The privatization process was contentious due to a historical deal between Solidarity and the communist governments that empowered enterprise insiders in the 1980s, both trade unions and managers, to reduce political tensions at the enterprise level.[577] Balcerowicz and his team of economists opposed transfer to workers and favored case-by-case privatization through direct sales, tenders, or auctions to outsiders to

[576] In its first economic program, the Mazowiecki government favored the classical concept of privatization– public offerings–based on the British model, combined with the rapid development of a new private sector. However, the British model was eventually rejected given the large number of enterprises to be privatized and the lengthy process of selecting enterprises to be made profitable prior to privatization.

[577] Enterprise self-management was the principal element of the Solidarity platform. During the 1981 reforms of the enterprise sector, employee self-management became part of a new set of decentralized measures to form state-owned enterprises that were intended to be made "self-dependent, self-managed, and self-financed" (known as Three S's). The legislation adopted in September 1981 made elected employee councils the principal strategic decision-making body in many Polish enterprises.

prevent insider worker groups and management from taking over the enterprises.[578] The authors of the Polish privatization plan were thus under strong pressure from the self-management movement, which had a strong voice in privatization and had called for greater employee share ownership.[579] In the end, the Mazowiecki government decided on a compromise solution, a "multi-track" approach to privatization that was reflected in the July 1990 State Enterprises Privatization Act (Article 37). This compromise resulted in direct sales to strategic investors and via the stock market, employee-management buyouts or leases, and mass privatization.[580]

In order to speed up privatization, plans were prepared for a mass privatization program that used vouchers. The mass privatization scheme was first elaborated on and promoted by two liberal economists from the Gdansk Institute of Market Economics, Janusz Lewandowski and Jan Szomburg (1990) (the latter became the Minister of Ownership Transformation).[581] The law prepared in mid-1991 was approved by the Parliament in April 1993 (known as the National Investment Funds Law) but the legislative approval did not allow the process to start immediately. Rapid, large-scale mass voucher privatization was delayed in Poland because of

[578] Krzysztof Lis, the first director of the Agency of Ownership Transformation, proposed the transformation of enterprises into joint stock companies without employee councils, limiting worker share ownership to a maximum of 20 percent. Author's interview with Stanislaw Gomulka, former Advisor to Balcerowicz and Reader in Economics at the London School of Economics, July 13, 2006, Warsaw.

[579] Author's interview with Michal Federowicz, Institute of Philosophy and Sociology, Polish Academy of Sciences, July 4, 2006, Warsaw.

[580] For analyses of the Polish privatization process, see Orenstein (2004), Appel (2004), Simoneti (1993), Jarosz (2000).

[581] Lewandowski suggested establishing five to twenty National Property Boards (the equivalent of a holding company) among which 60 percent of the shares of the 400 largest enterprises in "good condition" would be distributed. The Treasury would retain 30 percent of the shares of these enterprises and the remaining 10 percent would go to employees free of charge. The Boards were intended to act as supervisory bodies that would bring in foreign expertise and ensure that enterprise restructuring would take place. However, the plan was heavily criticized. Its critics pointed to the danger of creating "super-ministries" or industry-wide holding companies that would resemble WOGs, i.e., large economic units introduced in Poland in the early 1980s that would control both enterprise and the market (Hashi 2000).

political pressure by trade unions and the victory of the left-wing government in 1993. The Polish people voted the Polish Solidarity reformers out of power after a wave of protests. By the September 1993 elections, the Solidarity camp had disintegrated to several factions, and the former communist party (the Democratic Left Alliance, SLD) formed a government coalition with the ex-communist satellite Polish Peasant Party (PSL). Until the 1997 elections, the SLD controlled 66 percent of the seats. The new left government finally implemented, in two waves, a delayed mass privatization program in July 1995 and December 1995 (two waves). But even then, Polish mass privatization was limited, affecting only 512 mostly medium-sized enterprises that represented only 5 percent of GDP. Shares of these participating enterprises were distributed according to a common scheme among fifteen National Investment Funds (NIFs) (60 percent), the Treasury (25 percent), and employees (15 percent) for each enterprise.[582] The primary objective for the NIFs (closed-ended investment funds) was to restructure the enterprises and sell them to either strategic owners or on the stock exchange (Grosfeld and Hashi 2004).[583]

The Polish mass privatization scheme sharply contrasted to the Czech program in several respects. First, while the Polish program applied a uniform distribution scheme of enterprise shares, in the Czech program, the outcome of the bidding process was nontransparent. Any number of funds and outside parties could become the new owners of privatized enterprises. Thus, while the Czech and Slovak investment funds developed spontaneously by public or private entities, the Polish NIFs were established by the state.

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[582] The Polish citizens were entitled to buy privatization vouchers (certificates) between November 1995 and November 1996 for a token price of 20 zloty. The citizens did not become direct enterprise shareholders but certificates entitled them to one share in NIFs, thus they become indirect private enterprise shareholders. Of the people who were qualified, 96 percent (26 million) bought the certificates.

[583] See Hashi (2000) for a detailed examination of the operations of the NIFs.

Second, the Polish NIF management was entrusted to a special consortium of domestic and foreign financial institutions selected through an international tender offer, in order to bring in fund management know-how and ensure that Polish institutions learned from their foreign partners. In contrast to the Czech government's approach to privatization that favored domestic over foreign capital, the involvement of foreign financiers in Polish privatization was welcome. However, it should be noted that the Polish Parliament originally rejected mass privatization in 1993. This rejection took place mainly because right-wing members of the government coalition believed that having foreign banks managing NIFs would lead to excessive foreign influence in the Polish economy, and that was unacceptable to most of the population (Orenstein 2004: 121).

Finally, the Polish privatization law prevented cross-ownership of banks and industries because Polish banks participating in the consortia were not included in the voucher scheme or they were already privatized and limits on NIFs borrowing were imposed (Grosfeld and Hashi 2004: 13, Baltowski and Mickiewicz 2000: 437–8). Not only did the government hold the view that banks should not be enterprise owners, but the banking elite themselves were not interested in acquiring shares in privatized enterprises or maintaining close relations with them. In contrast to the Czech or German banks, Polish banks were not willing to support domestic industries.[584] Therefore, the success of Polish privatization was mainly due to strict regulation of bank lending and independent asset management by a small group of vetted enterprises (Horowitz and Petráš 2003: 247, fn. 35).

In sum, Polish enterprise privatization demonstrated a variety of paths and procedures, distinguishing it from the voucher privatization in the Czech Republic,

[584] Author's interview with Michal Federowicz, Institute of Philosophy and Sociology, Polish Academy of Sciences, July 4, 2006, Warsaw; author's interview with Piotr Kozarzewski, Senior Expert, Center for Social and Economic Research, July 5, 2006, Warsaw.

which was more uniform in nature. At the end, under competitive pressures, Polish state-owned enterprises were most typically restructured and privatized for foreign strategic investors. Fully foreign-owned enterprises accounted for 40 percent of foreign direct investment in 1993, and 50 percent in 1998 (King and Sznajder 2006: 778). As I discuss in the subsequent section, enterprise privatization coupled with far reaching liberalization of the financial sector and privatization with foreign participation reduced the political power of incumbent industrialists and financiers.

Financial Development: Decentralization and Foreign Participation

Two pieces of legislation, the Act on the National Bank of Poland and the Banking Act, modeled on German legislation, laid the foundation for the establishment of a two-tier banking structure in Poland in 1989.[585] The new legislation allowed the transformation of nine regional agencies of the central bank—the National Bank of Poland (*Narodowy Bank Polski*, NBP)—into independent SOBs, while the NBP assumed the role of a classical central bank. Still, in reality, it was not until 1994 that the NBP put an end to its commercial activities. Thus, nine SOBs were created from the *voivodship* and former country bank branches of the NBP including: Wielkopolski Bank Kredytowy (WBK) in Poznan, Bank Slaski (BSK) in Katowice, Bank Przemyslowo-Handlowy (BPH) in Krakow, Bank Gdanski (BG) in Gdansk, Pomorski Bank Kredytowy (PBKS) in Szczecin, Bank Depozytowo-Kredytowy (BDK) in Lublin, Bank Zachodni (BZ) in Wroclaw, Powszechny Bank Gospodarczy (PBG) in Lódz, and Powszechny Bank Kredytowy (PBK) in Warsaw.

Prior to the collapse of communism, the Banking Act of 1982 had already allowed the establishment of new banks. In addition to nine regional SOBs, four

[585] Before 1989, the Polish banking system underwent various partial reforms but these were not successful in radically changing communist banking.

specialized SOBs operated in Poland at the outset of transition: Bank Handlowy w Warsawie S.A. (BH), the foreign trade merchant bank; Bank Polska Kasa Opieki S.A. (Pekao), a savings bank handling foreign currency transactions involving individuals; Bank Gospodarki Zywnosciowej S.A. (BGZ), a national umbrella bank for local cooperative banks involved in the financing of agriculture and food processing; Powszechna Kasa Osczednosci-Bank Panstwowy (PKO BP), a savings bank specializing in zloty household deposit-taking and in financing housing construction.[586] In 1990, the government also liberalized the "third" tier of the banking system, the cooperative banking sector. Cooperative banks were allowed to leave the BGZ, which was the main supervisory body for these banks.[587]

The 1989 law on banks further permitted the establishment of new banks organized as joint-stock companies with the participation of both Polish and foreign banks, and it legalized the operations of foreign banks in Poland. Believing that foreign investors bring foreign competition that would help reform the Polish banks, the government also encouraged greenfield investments in the financial sector (Epstein 2008). The government provided incentives for foreign banks (and foreign enterprises) to enter the Polish market by exempting them from paying corporate tax for three years and allowing them to repatriate their profits. Nonetheless, if a foreign bank

[586] In addition to these banks, six other banks complete the list of the largest 19 banks in Poland. Bank Rozwoju Eksportu S.A. (BRE) was established in 1986 as an export development bank by the NBP, the Ministry of Finance, the Ministry of Foreign Economic Relations, and two banks specialized in foreign transactions, BH and Pekao. Polski Bank Rozwoju (PBR) was established in 1990 as a development bank to aid in restructuring and privatizing state-owned enterprises. Pierwszy Komercyjny Bank (PKB) was founded in 1991 to specialize in factoring. Polski Bank Inwestycyjny (PBI) was established in 1993 to take over nonqualified assets from the NBP's portfolio and foreign exchange account liabilities matched by dollar-denominated bonds issued by the Ministry of Finance. Both PKB and PBI are wholly owned by the NBP. The above description of the initial structure of the Polish banking sector relied upon Bonin and Leven (2001) and Abarbanell and Bonin (1997).

[587] Following mergers and bankruptcies, the numbers of cooperative banks have fallen from 1653 in 1993 to 902 in 1999.

wanted to obtain a license, it was required that at least one member of the bank's managing board had a Polish citizenship. Initially, the dominant investment strategy of foreign banks was to establish a new bank or to participate in founding a bank with Polish partners.[588]

At the beginning, the NBP conducted a very liberal bank licensing policy, issuing 42 licenses in 1990 alone (Polanski 1997: 66). As a result, many "crony" private banks were established by state-owned enterprises or local governments. These newly established banks were generous in extending credits.[589] Similarly, although subsidies from the state budget were discontinued, SOBs continued their liberal lending policy to a privileged group of customers, mainly to large state-owned enterprises. In particular, BGZ, an ally of the Peasant Party, granted extensively politicized credits to agricultural producers.[590]

The monetary authorities attempted to contain these expansive credit policies and reduce the capacity of incumbent banks to create money by raising interest rates and requiring reserves of 30 percent on deposits. But the enterprises were borrowing, in spite of high interest rates, to maintain liquidity. Rapid growth in credit accelerated growth in the money supply. In spite of very high level of nominal interest rates (103 percent in 1990, 53 percent in 1991, and 39 percent in 1992), the NBP's policy did not seem to be restrictive enough. The inflation rate was declining only slowly. Real interest rates remained negative and interest spread high (Polanski 1997). The

[588] The first foreign banks entering the Polish market included the American Bank in Poland in 1989, the Dutch ING in 1990, Citibank (merging with BH in 2001), the Austrian bank Creditanstalt (merging with PBK in 2001), and Raiffeisenbank in 1991.

[589] Author's interview with Wlodzimierz Grudzinski, President of the Bank for Socio-Economic Initiatives and Member of Management Board of the Association of Polish Banks, July 16, 2006, Warsaw. Also, Polanski (1997: 65).

[590] Author's interview with Stefan Kawalec, former General Director in the Ministry of Finance and Chief Advisor to Deputy Prime Minister Balcerowicz (1989-1991), Deputy Minister of Finance (1991–1994), July 16, 2006, Warsaw.

OECD's estimates of interest rate spreads for the banking sector were 7 and 9 percentage points in 1992 and 1993 (Montes-Negret and Papi 1996: 20).

The Polish banks initially favored the inflationary environment of the early years of transition, for this environment guaranteed the banks profits from high interest rate differentials. They were not keen supporters of anti-inflationary policies but they had limited channels to influence the decisions of monetary authorities.[591] High interest rate spreads also encouraged banks to speculate on Treasury bills and the NBP's sterilization bonds.[592] When the zloty was pegged to the U.S. dollar in 1990, the Polish banks made large profits by purchasing dollars for their current business transactions at a fixed rate in spite of significant appreciation in the real effective exchange rate. These profits increased the capital base of the banks at the time when bad loans had not yet become a serious problem (Bonin 1993: 109). The reckless borrowing from banks resulted in corporate sector payment problems, including inter-enterprise arrears and overdue enterprise debts, and subsequently in bad credit portfolios of banks. Then, the chief economists of domestic banks would start publicly expressing their preferences for a flexible exchange rate regime.[593]

Although the banks enjoyed high profits in 1990, the share of bad loans in bank portfolios had risen dramatically by 1991. In mid-1991, bad loans represented 17 percent of total credits granted by Polish banks but had a weighted average of 42

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[591] Author's interview with Andrzej Topinski, former Vice-President of the NBP (1989–1992), President of the Association of Polish Banks, July 14, 2006; author's interview with Andrzej Bratkowski, former Advisor to Balcerowicz, Deputy President of the NBP, and Chief Economist of Bank Pekao SA, July 17, 2006, Warsaw.

[592] Author's interview with Stefan Kawalec, former former General Director in the Ministry of Finance and Chief Advisor to Deputy Prime Minister Balcerowitz (1989–1991), Deputy Minister of Finance (1991–1994), July 16, 2006, Warsaw.

[593] Author's interview with Marek Dabrowski, former First Deputy Minister of Finance (1989–1990), Member of Parliament (1991–1993), and Member of the Monetary Policy Council of the NBP (1998–2004), July 3, 2006, Warsaw.

percent of the credit portfolios of the nine SOBs (Gomulka 1993). For the most part, many of these bad loans were the outcome of the political allocation of credit during the communist period as well as the communist legacy of bank-enterprise links that led to a continued flow of credit to enterprises that enabled them to repay old debts. Anti-inflationary monetary policy and suppression of subsidies, in addition to the collapse of CMEA, aggravated the situation of many exporters and contributed to a high number of bad loans on bank balance sheets (Polanski 1997: 74). As a result, the Polish banking system experienced a mini crisis around 1991 that culminated in 1993. The crisis resulted in the liquidation of six banks, while ten cooperative banks were declared bankrupt (Polanski 1994: 34).

The Polish government reacted by changing the emphasis in its approach to the banking system from establishing new banks to privatizing SOBs. The World Bank had already recommended privatizing banks in 1989 because it feared destabilizing expansive bank credit policies. Nevertheless, at that time, the Polish government preferred to restructure banks prior to their privatization, even though it was committed to SOB privatization from the outset of the transition.[594] The program for the privatization of the banking sector was adopted by the Economic Committee of the Council of Ministers in 1991. According to the original timetable, nine SOBs carved out of the NBP were supposed to be privatized by the end of 1996, so these banks were transformed into joint-stock companies.There was a political will to privatize the banking sector quickly and consistently with a privileged position reserved for foreign investors.[595] The Polish reformers were convinced that due to a lack of sufficient

[594] Author's interview with Stanislaw Gomulka, former Adviser to Balcerowicz and Reader in Economics at the London School of Economics, July 13, 2006, Warsaw.

[595] Author's interview with Katarzyna Zajdel-Kurowska, Chief Economist and Head of Treasury Research, Citibank Handlowy, July 14, 2006, Warsaw.

national capital, the privatization of SOBs could not take place without involving foreign investors. In fact, the objective of the Polish program for bank privatization was to find a foreign strategic investor for each SOB (Szymkiewicz 2001: 66). The motive of the Polish reformers was to strengthen the prospects of domestic banks with the active involvement of a foreign strategic investor so that bank privatization would provide budget revenues to finance reforms in other areas (Mortimer 1995: 96).

To encourage bank privatization, Western donor countries (of which the United States was the largest contributor) allowed the use of 600 million U.S. dollars from the Bank Privatization Fund to recapitalize banks. This fund, established in 1992, was originally created to support the fixed exchange rate (the Zloty Stabilization Fund) (Mortimer 1995: 96). The funds were not used to support the zloty, so donors decided to make them available to support bank privatization. However, the donors allowed for disbursements to finance the recapitalization of a commercial bank only after it was privatized (Abarbanell and Bonin 1997: 32).

To this end, the original blueprint of the bank privatization strategy focused on finding a strategic investor for a privatized bank which would possess no more than 30 percent of total shares but would actively participate in bank management; the Ministry of Finance would retain about 30 percent of the shares with voting rights limited to strategic decisions; and the remaining shares would be offered to employees and individual investors in a public offering (Szymkiewicz 2001).[596] Bank privatization combined initial public offerings and placement with foreign investors via direct sales.

[596] The government's intention was to attract capital from various countries and to prevent the domination of German capital. Author's interview with Dariusz Filar, Member of the Monetary Policy Council of the NBP, July 11, 2006, Warsaw.

The government has chosen two banks to spearhead the privatization program. These banks are considered to be among the best Polish banks in terms of both quality of their portfolios and management (top-level managers were previously the NBP managers). The privatization of WBK, the first of the nine regional SOBs, started in June 1991. Although the government searched for a foreign strategic investor, due to the initial lack of interest, it subsequently decided to sell 29 percent of its shares to the EBRD to provide a counterbalance to the state's influence in bank governance, rather than delay privatization (Bonin 1993: 111–112). In 1993, the Dutch ING acquired 26 percent of shares in BSK (at present ING owns 88 percent of the shares). By the end of 1995, an additional three of nine SOBs were privatized: BSK in 1993, BPH and BG in 1995 (Bonin and Leven 1996).

As the result of the financial liberalization and privatization in 1993, 58 out of the 87 operating commercial banks were controlled by private owners. Initially, the number of foreign owned banks in the Polish banking system was relatively small. In 1994, out of 81 banks, only 11 (14 percent) were controlled by foreigners. In spite of the liberal policy of foreign bank entry and various incentives provided by the Polish government to foreign investors, "foreign banks were initially reluctant to get involved in privatization of Polish banks because of the country's difficult situation with debt reduction," recalls Stefan Kawalec, Chief Adviser to Balcerowicz in charge of financial reforms.[597] Although an agreement with the Paris club creditors had already been signed in 1991, reducing debt by 50 percent, the agreement with the London Club reducing outstanding debt by 45 percent was not reached until 1994 (Polanski 2002, Angreasano 1996). This agreement constituted the starting point for the

[597] Author's interview with Stefan Kawalec, former General Director in the Ministry of Finance and Chief Advisor to Deputy Prime Minister Balcerowicz (1989–1991), Deputy Minister of Finance (1991–1994), July 16, 2006, Warsaw.

expansion of foreign bank in the Polish financial system. Since 1994, the role of foreign capital in the Polish banking sector increased significantly.

At the same time, the number of licenses for new banks fell from 16 in 1991 to five in 1992 and to only one each in 1993 and 1994 (Polanski 1997: 66). From 1992 to 1996, only 20 new licenses were granted, mainly to foreign banks (Szymkiewicz 2001: 56). But this temporary freeze on granting new licenses also affected greenfield operations of foreign banks. Instead, the NBP encouraged foreign banks to take over small ailing Polish banks, a policy that was successful only in one case (Interbank was taken over by ABN AMRO) or to participate as strategic foreign investors in the privatization of SOBs (Konopielko 1999: 479–482). The principal objective of the NBP was to strengthen the domestic banking system through the restructuring and revitalization of domestic banks with the assistance of foreign capital. Seven of the "nine" regional SOBs participated in "Twinning Agreements" with foreign partners in the framework of the IMF and World Bank programs. However, these programs were only moderately successful because only one bank, Allied Irish Bank, invested in its "twin," WBP (still, at present, Allied Irish owns 60 percent of WBK's shares) (Epstein 2001). Even though foreign banks preferred greenfield investments early on, later they ended up taking over the Polish banks (brownfield investments) (Szymkiewitz 2001: 64). By 1996, foreign financial institutions controlled 30 percent of total banking sector capital (Konopielko 1999: 479).

Contemporaneous with the privatization program, a bank-led, enterprise-restructuring plan was designed. The focal point in bank privatization and managing problematic bad loans (collected before 1992) was the 1993 Law on Financial Restructuring of Enterprises and Banks. Poland adopted a bank-led "decentralized" approach to restructuring. According to the plan, no special government institution has been created and banks themselves were expected to solve the problem of non-

performing loans. Instead, the World Bank recommended a standard procedure for cleaning up bad loan portfolios (applied previously in Spain and some Latin American countries), which envisaged the transfer of bad loans from banks to so-called "bank hospitals," responsible for restructuring. Nonetheless, the Polish Ministry of Finance was skeptical about the efficient functioning of a centralized government-run restructuring agency and its ability to resist political pressures.[598] The centralized approach to bad loan problems, which was implemented by the Czech government, has proven to be unsuccessful in changing the rent-seeking behavior of Czech banks and enterprises, as chapter 7 demonstrates.

In a decentralized Polish approach, banks and enterprises were encouraged to reach a conciliatory agreement, which could have taken one of the following forms: rescheduling claims, debt/equity swaps and loan write-offs, bankruptcy, liquidation, or sale of claims. The government clearly announced that it would not play an active role during the conciliation proceedings. The "lead" bank in a bank conciliation procedure was responsible for monitoring the agreement and was held accountable for the losses of other creditors if the agreement was not completed on time or if the bank did not terminate the agreement when it was breached. The lead bank thus took responsibility for resolving the debt of its major clients in return for one-time recapitalization with interest bearing government bonds ("restructuring bonds") with a 15-year maturity to create adequate provisions against bad debts. Thus, the restructuring program included a one-time recapitalization of seven of the nine main commercial banks, which held about 60 percent of outstanding enterprise debt, sufficient to deal with classified debts originating prior to 1992. The program also imposed a formal ban on granting new loans to enterprises with doubtful or non-collectible loans and a one year deadline for

[598] Author's interview with Stefan Kawalec, former General Director in the Ministry of Finance and Chief Advisor to Deputy Prime Minister Balcerowicz (1989–1991), Deputy Minister of Finance (1991–1994), July 16, 2006, Warsaw.

completing the restructuring program. This ban made banks reluctant to reschedule the payment of old loans because they were skeptical that their debtors could meet such a tight repayment schedule. More importantly, a bank-led enterprise-restructuring plan, unique among transition countries, linked bank privatization and recapitalization directly to bad-debt workouts. Technical assistance was provided by consortia composed of Polish and foreign consulting firms (McDermott 2006 and 2007: 230, Kawalec and Kluza 2003).

The restructuring program and the commitment of the government to privatize the SOBs involved in the program, successfully contained moral hazard and changed the behavior of domestic banks. In the words of Andrzej Bratkowski:

> Moral hazard was contained because the government made it clear that after the first stage of recapitalization, nobody could expect a bailout. Polish banks were in a weak position to lobby because they were aware that they could not expect further money from the government. Therefore, they preferred to cooperate with foreign banks.[599]

Banks learned how to deal with financial risks, and bad loan problems have not reemerged in the banks covered by the restructuring (Van Wijnbergen 1997).[600] As a result, during the period between recapitalization and privatization, "the banks retained capital adequacy and were profitable. They did not need further infusions of capital by the government and ultimately were sold to strategic investors with high premiums to their book values" (Kawalec and Kluza 2003: 7). Thus, in contrast with

[599] Author's interview with Andrzej Bratkowski, former Advisor to Balcerowicz, Deputy President of the NBP, and Chief Economist of Bank Pekao SA, July 17, 2006, Warsaw.

[600] There were some instances in which banks continued to behave badly, however. Bonin and Leven (2001) examined the performance of BDK and found that the bank continued to provide soft lending to keep four old-military industrial enterprises afloat and even increased its credit exposure to these enterprises during the bank-led bad resolution program.

Bulgaria and the Czech Republic, where the governments engaged in multiple bank recapitalizations, the recapitalization of SOBs in Poland has been carried out only once. Since the Polish government made it clear at the beginning of the transition that it would not be "paternalistic," bank managers realized that if they wanted to survive, they had better not engage in imprudent credit policies and excessive risk taking.[601] At the same time, bad loans decreased, amounting to 11 percent in 1998 (Szymkiewicz 2001: 57, Polanski 2002: 112).

The SLD-led government that came to power in 1993 made some attempts to change the privatization strategy that had been practiced previously. In 1994, the SLD-affiliated Minister of Finance Kolodko wanted to put off bank privatization, and instead commercialize a number of SOBs and consolidate them into two groups (around Bank Handlowy and Pekao SA) for two reasons: to maximize the state's revenues from privatization and to facilitate acquisitions by domestic buyers to maintain the state's role in bank management and credit allocation. He believed that rapid bank privatization would unfairly favor foreign investors given the underdeveloped Polish financial market. By postponing privatization, he intended to maintain the government's role in credit allocation and to eventually create a Polish-owned international competitive banking conglomerate. These goals were included in the Bank Consolidation Plan that the Ministry of Finance under Kolodko's direction announced in 1995. According to the plan, Polish banks were considered to be too small to survive the invasion of foreign banks after the liberalization of entry, which was required by the EU Association Agreement (Epstein 2001 and 2008).[602] In

[601] Author's interview with Zbigniew Polanski, Advisor to President of the NBP Leszek Balcerowicz and Professor of Economics, Warsaw School of Economics, July 11, 2006, Warsaw.

[602] By 1996, two bank groups had been created under the Consolidation Act: Pekao SA merged with three regional banks, PBG, BDK and PBKS; and PBR merged with PBK. At the same time, two private-led banking groups emerged: the first led by BIG with its purchase of a core stake in the privatization of BG and the second led by Kredyt Bank, which had acquired PBI (Konopielko 1997).

general, the banking sector in Poland was perceived to have close links with left wing parties because at the beginning of the transition, the members of the anti-communist opposition movement were mainly dissident intellectuals, and the only people with business experience were ex-communist managers in state-owned enterprises and banks.[603] Members of PSL, the SLD coalition partner, were strongly against privatization and foreign participation in the ownership of the agricultural bank BSK.

Nonetheless, in 1996, under the pressures from the IMF and other international institutions, the plan for bank consolidation and strengthening of domestic ownership was dropped and a fast-track privatization through direct sales with foreign capital resumed (Epstein 2008).[604] In the same year, the Cimoszewicz government launched a new ambitious privatization plan to privatize ten banks between 1997 and 2000. Cimoszewicz's plan was, however, only partially implemented due to the government's defeat in the elections of October 1997. After that point, the new government accelerated the sale of SOBs principally to foreign banks. By the end of the 1990s, 70 commercial banks (out of 77) were in private hands, while 39, over half, of the commercial banks were owned by foreigners (Polanski 2002: 109). The most important was the privatization of Pekao SA, the second largest Polish bank (with 20 percent of the Polish banking system assets) to Unicredito Italiano and Allianz AG, which had acquired a 52 percent stake. In 2001, the asset share of foreign banks in the Polish banking sector represented 69 percent.

[603] Author's interview with Andrzej Bratkowski, former Advisor to Balcerowicz, Deputy President of the NBP, and Chief Economist of Bank Pekao SA, July 17, 2006, Warsaw.

[604] Social democrats often criticized the rapid privatization of banks in the second half of 1990s, arguing that it went too far and that the banks did not support domestic industries. Author's interview with Jerzy Hauser, former Minister of Labor, Minister of State Treasury (2004), Minister of Economy (2003–2005), July 6, 2006, Warsaw.

As foreign owned banks started to dominate the Polish financial system, most of these banks intensified competition. Simultaneously, the Polish authorities strengthened the regulatory and supervisory framework in the banking sector. The NBP, from the beginning, obliged banks to measure credit risk and to cover it by specific provisions. In some areas, similar to the loan classification criteria, Polish regulations were even more restrictive than those in the EU countries (Polanski 2006). Although banks tried to lobby for weaker regulation, through lower mandatory reserves for example, they were not able to exert influence on government regulatory policies. Unlike the Czech regulatory authorities, the Polish government was able to limit bank speculation on international financial markets because tight prudential regulations and limits to the foreign exchange positions of commercial banks had already been introduced in 1993, before capital flows were liberalized. Banks were thus compelled to behave in a risk-adverse manner.[605] Although banks favoured liberalization of capital early on, the Polish authorities adopted a gradual and cautious liberalization schedule.[606] While inflows of foreign direct investments had already been liberalized in 1991, short term restrictions on capital were not removed until 2002. Poland's obligations related to the OECD accession in 1996 did not substantially accelerate liberalization, either.[607] In fact, Polish regulations of capital movements fell short of OECD requirements (Árvai 2005: 11–12).

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[605] Author's interview with Piotr Spzunar, Deputy Director, Macroeconomic and Structural Analyses Department of the NBP, July 3, 2006, Warsaw.

[606] Author's interview with Katarzyna Zajdel-Kurowska, Chief Economist and Head of Treasury Research, Citibank Handlowy, July 14, 2006, Warsaw.

[607] Poland's application for the OECD membership required fulfilling obligations resulting from the OECD Codes of Liberalization. Consequently, a new Foreign Exchange Law adopted in January 1995 codified liberalization of non-resident portfolio investment in equity and the liberalization of foreign investment in domestic treasury securities, which took place from 1992 through 1994, and allowed the selling of Polish securities on international markets. However, many capital controls remained in place and Poland was obliged to remove the remaining capital restrictions by the end of 1999.

Polish SOBs gradually began to change their behavior in the face of the approaching "corporatization" and privatization (Polanski 1994: 38). Surprisingly, the banking sector itself had become active in introducing foreign capital from the outset of the transition. Bankers understood that it was better to adapt to competition from Western banks than to build on the former post-communist networks.[608] The other reason why banks were motivated to get privatized was because of what was offered to their own employees and managers under the government privatization scheme.[609]

In summary, the Polish governments conducted a gradual bank privatization (case-by-case approach) that privileged sales to foreign strategic investors as multiple objectives were tried including attracting foreign investors but also raising budget revenues from the sale of the banks, promoting enterprise restructuring, and protecting the stock market as well as promoting a domestic presence in the financial sector (Abarbanell and Bonin 1997: 32).[610] Privatization of banks generated substantial revenues to the state budget (Polanski 2002). Another major goal of the Polish government in conducting bank privatization and restructuring that combined "delegation," "deliberation," and collective evaluation was to reduce asymmetric information on the side of the government and banks. This approach led to limiting favoritism to domestic enterprises by banks and the government (McDermott 2004). As a result, the Polish approach to financial development generated substantial revenues to the state budget and resulted in an open financial system. This system had strong banking regulations and supervision that prevented a systemic banking and

[608] Author's interview with Michael Federowicz, Institute of Philosophy and Sociology, Polish Academy of Sciences, July 4, 2006, Warsaw.

[609] Author's interview with Stefan Kawalec, former General Director in the Ministry of Finance and Chief Advisor to Deputy Prime Minister Balcerowicz (1989–1991), Deputy Minister of Finance (1991–1994), July 16, 2006, Warsaw.

[610] Abarbanell and Bonin (1997) criticized these objectives as being mutually inconsistent.

financial crisis and enabled the government to conduct a sustainable exchange rate policy.

The Consensual Exchange Rate Policy

With the central bank at the center, the financial system that emerged in Poland allowed a consensus among banks, industries, and the state in monetary, regulatory, and exchange rate policies. The NBP was thus an indispensable part of this institutional framework. Throughout the 1990s, the Polish monetary authorities pursued an "eclectic" exchange rate policy, focusing both on exchange rate and interest rates, a "competitiveness-conscious" strategy. In its quest to reduce inflation, Poland has not tolerated a highly valued Polish zloty irrespective of considering the competitiveness of domestic industries.

While ties between banks and enterprises were market based, the NBP did not enjoy the same degree of independence from the government as its Czech and Estonian counterparts. During most of the 1990s, Ministry of Finance and Ministry of Foreign Relations bureaucrats as well as the Parliament dominated the NBP not only in exchange rate policy but also in domestic monetary policy. Although the 1989 law on the central bank stipulated that the governor of the NBP would be nominated by the President and confirmed by the Sejm (the lower house of the Polish Parliament), the requirement remained unchanged that the annual monetary program of the central bank required direct parliamentary approval. Therefore, the Parliament had preserved a significant role in the conduct of monetary policy and in overseeing the NBP's activities (Kochanowicz, Kozarzewski, and Woodward 2005: 49). In general, the co-objective of the central bank was to cooperate with the government in pursuing the objectives of national economic policy.

Similarly, the decisions on exchange rate policy and financial liberalization were much more involved than in the Czech Republic and Estonia because several parties participated in the decision-making process. The Polish legislation stipulated that the principles for establishing the exchange rate were to be determined by the Council of Ministers upon a proposal from the President of the NBP in consultation with the Minister of Finance and the Minister of Foreign Relations. Therefore, the final decision in exchange rate policy area rested with the Council of Ministers (Koch 1997: 7). The ambiguity of the law on the NBP lent itself to the right of the government to veto the decisions in the exchange rate policy area.[611] The decision-making in this area was further complicated by the need to find a compromise among the conflicting views of these three institutions: while the central bank focused on anti-inflationary objectives, the Ministry of Foreign Relations favored a weak currency to facilitate exports; and the Ministry of Finance was caught in between the two. For example, Kolodko, the SLD Minister of Finance saw support for an exchange rate as an anchor but also one that could promote growth.[612] Similarly, in the area of capital account liberalization, the Foreign Exchange Law stipulated the co-decision making shared by the NBP and the Ministry of Finance.[613]

As argued previously, during the 1990s, the Polish government pursued an approach to exchange rate policy in which the real exchange rate should be stable and set at a competitive level. Even though it was not stated in official documents, it

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[611] Author's interview with Marek Dabrowski, former First Deputy Minister of Finance (1989–1990), Member of Parliament (1991–1993), and Member of the Monetary Policy Council of the NBP (1998–2004), July 3, 2006, Warsaw.

[612] Author's interview with Grzegorz Kolodko, former Minister of Finance (1994–1997 and 2002–2003), July 2 and 5, 2006, Warsaw.

[613] Author's interview with Piotr Szpunar, Deputy Director, Macroeconomic and Structural Analyses Department of the NBP, July 3, 2006, Warsaw.

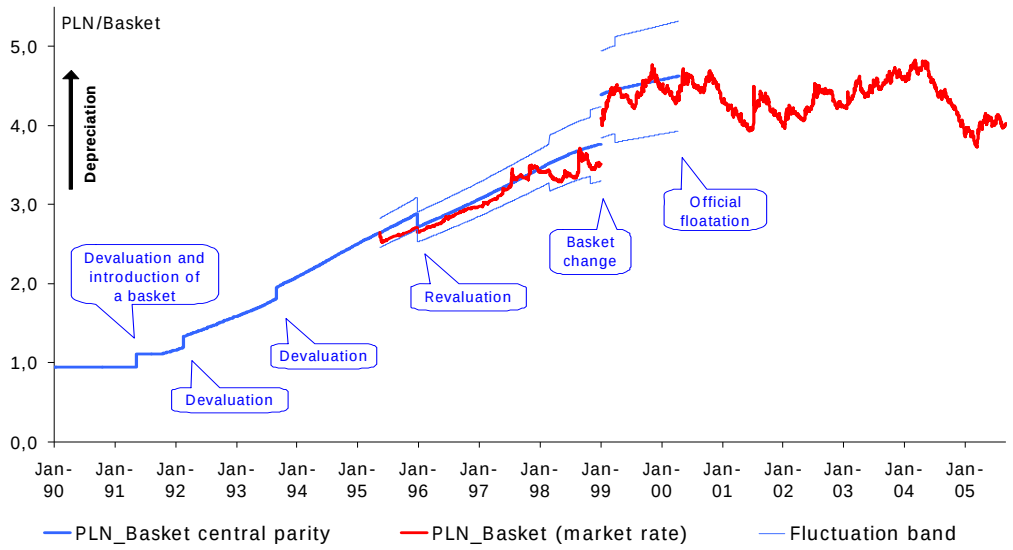
seemed there was an assumption right from the beginning that a form or crawl might follow the rigid peg when the real exchange rate appreciated substantially (Gomulka 1995: 336). The Polish exchange rate policy throughout the 1990s aimed to achieve a compromise between disinflation objectives and competitiveness of domestic industries on international markets.[614] Once the accelerating inflation was brought under control and due to various domestic pressures, the Polish government gave low priority to further reductions in inflation and tried to sustain the competitiveness of domestic exporters (Burdekin, Nelson and Willett 1999).

A currency peg adopted as a part of the economic stabilization program at the beginning of the transition reduced the inflation rate very quickly from four digit numbers but relatively high inflation persisted (only in 1998, for the first time, was there a yearly consumer price index of one digit). The single currency peg to the U.S. dollar exposed it to changes in the international value of the dollar at the time when Polish trade with European countries increased. The government thus devalued the zloty in May 1991 after sixteen months and pegged it to a basket of five currencies.[615] Inflation differentials combined with a fixed exchange rate led to a quick appreciation of the zloty, which in turn led to a sharp increase in imported consumption goods and put strong pressure on the competitiveness of domestic exporters. The government reacted by introducing a compromise solution: a pre-announced crawling peg to a currency basket in October 1991. The crawling peg allowed for very limited exchange rate flexibility, so the exchange rate continued to be a nominal anchor for disinflation policy. Nevertheless, the rate of crawl was to ensure a competitive exchange rate at the

[614] Author's interview with Jerzy Pruski, First Deputy Governor of the NBP, July 12, 2006, Warsaw.

[615] In May 1991 the zloty was devalued by 14 percent against the U.S. dollar and became pegged to a basket of five currencies reflecting their relative importance in Polish trade (45% U.S. dollar, 35% Deutsche mark, 10% British pound, 5% French franc, and 5% Swiss franc).

same time.[616] Against the background of continuous problems of controlling inflation and accelerating capital flows, the NBP introduced a crawling band, in May 1995 and the zloty was allowed to fluctuate in a band of plus or minus 7 percent. This strategy was intended to give the central bank more room for monetary policy maneuvers (Kokoszczynski 1997, Pruski and Szpunar 2005) (figure 1).[617]



Source: National Bank of Poland.

Figure 8.1: From hard peg to free float, 1990–2005

The soft peg policy that was pursued after abandoning a rigid peg in 1991 opened the NBP to conflicting pressures for devaluation from speculators and exporters (Kowalski and Stawarska 1999: 356). Although the export industries were profitable immediately after the entry devaluation before the 1990 fixing of the zloty,

[616] Monthly devaluations were set at 1.8 percent (23 percent annually) to 1 percent (12 percent annually) at the beginning of 1996. Decisions on devaluations were taken on the basis of the balance of payments and the foreign exchange levels, to preserve the competitiveness of domestic exporters (Koch 1997: 12).

[617] According to the definitions used in this study, both a crawling peg and a crawling band are fixed regimes.

they started to express their discontent when the exchange rate began to appreciate and the trade balance became negative. Two industries were particularly affected by the currency appreciation: the shipyard industry whose entire production was designated for exports and the coal industry, which was struggling with endless unsuccessful restructuring programs even though it was less dependent on exports.[618]

The different Polish governments limited their export promotion policy to managing the exchange rate (Campbell 2002: 506). They tended to avoid a pro-active industrial policy in the interventionist sense. Syryjczyk, the minister of industry and trade in the first post-communist Mazowiecki government, declared that "the best industrial policy is no industrial policy."[619] Some attempts to formulate industrial policy existed during the Suchocka administration, such as the establishment of the Agency for Restructuring.[620] Kolodko, a finance minister from the SLD/PSL coalition government, pushed more aggressively for a pro-industrial policy that would increase competitiveness on the part of Polish industry in his new "Strategy for Poland" (King and Sznajder 2006: 774). But because SLD was supported by new industrialists and bankers who emerged from the *nomenklatura* privatizations under the last communist government, it essentially continued with the business friendly policies of the first post-communist governments (Stone 2002: 111). The Polish governments implemented short-term industry support programs under the temporary pressures of

[618] Author's interview with Stefan Kawalec, former General Director in the Ministry of Finance and the Chief Advisor to Deputy Prime Minister Balcerowicz (1989–1991), Deputy Minister of Finance (1991–1994), July 16, 2006, Warsaw. In general, in spite of the nominal appreciation of the exchange rate, Polish exports performed quite well (Polanski 2004: 15).

[619] Author's interview with Jerzy Hausner, former Minister of Labor (2001–2003), Minister of State Treasury (2004) and Minister of Economy (2003–2005), July 6, 2006, Warsaw.

[620] Author's interview with Stanislaw Gomulka, former Advisor to Balcerowicz and Reader in Economics at the London School of Economics, July 13, 2006, Warsaw.

interest groups from coal mining, the defense industry, the steel industry, and textiles but they have not elaborated a long-term industrial policy strategy.[621]

Some good examples that illustrate the reluctance of the Polish governments to pursue an active industrial policy are the cases involving textiles and steel producers, which were the key industrial sectors crucial to industrialization under the communist regime. Because of their insulation from world markets during communism, they became uncompetitive internationally. These industries were politically important in terms of geographic concentration and employment. Therefore, they had a strong potential to pressure the government for help. In particular, when Poland signed the Association Treaty with the EU in 1993, the government came under pressure from these two "sensitive" sectors that were facing harsh competition with EU products. Under pressure from the steel sector, the government temporarily imposed import tariffs, but in general, the Polish government refrained from employing sector-selective trade protection policies (Campbell 2000).[622]

The monetary policy pursued by the central bank was also only mildly restrictive. The NBP initially resorted to discretionary methods in monetary policy and played an important role in inflationary financing of budget deficits. The first NBP Presidents—Hana Gronkiewicz-Waltz and Grzegorz Wojtowicz—were too weak politically and too reluctant to apply drastic monetary measures (table 8.2).[623] In spite of the initial plan to abolish selective credit policies, the NBP continued to provide

[621] Author's interview with Michal Federowicz, Institute of Philosophy and Sociology, Polish Academy of Sciences, July 4, 2006, Warsaw. For example, the industrial policy program for 1996–1997 "International Competitiveness of Polish Industry" made industries responsible for their own competitiveness.

[622] Poland's agricultural sector was hit even harder because it was competing with the heavily subsidized agricultural products of the EU member countries. Still, it did not receive government support. Concentrated industrial exporters were more influential than dispersed agricultural producers.

[623] Author's interview with Andrzej Bratkowski, former Advisor to Balcerowicz, Deputy President of the NBP, and Chief Economist of Bank Pekao SA, July 17, 2006, Warsaw.

privileged conditions for some sectors of the economy, which included investments in government infrastructure (Polanski 1994: 38, fn. 39). Already in the second half of 1990, the NBP lowered refinancing and rediscount credit rates, triggered by the initial fall in inflation and pressure from industrial interests. But this step has proved to be premature and has again led to higher inflation (Kowalski and Stawarska 1999: 362). The government repeatedly pushed the NBP to lower interest rates that would reduce the attractiveness of the zloty to investors and the value of the zloty to boost Polish exports.

Table 8.2: Governors of the National Bank of Poland, 1989–2007

Governor	Tenure	Background
Grzegorz Wójtowicz	1991–1992	Central Banker
Hana Gronkiewicz-Waltz	1992–2000	Professor of Law
Leszek Balcerowicz	2000–2006	Politician (Prime Minister and Minister of Finance)
Slawomir Skrzypek	2007–	Banker (Chairman of PKO BP)

The NBP also financed the government deficit, which meant monetary accommodation of fiscal policy that fueled inflation. Initially, in the legal framework of the stabilization program, it was postulated that the NBP was not allowed to finance more than 2 percent of state budget expenditures per year and that all loans to the government should bear interest. Nonetheless, since 1992, the NBP started to acquire short-term Treasury bills issued by the government and it became the main finance provider for the state budget deficit (Polanski 1994: 17). While soft-budget constraints and the expansive credit policy of banks led to inflationary pressures in the Czech

Republic, the monetization of the fiscal deficit by the NBP acted as the "motor of inflation" in Poland (Wellisz 1997). The NBP financed 100 percent of the government deficit in 1989, 80 percent in 1991, 52 percent in 1992, and 65 percent in 1993.

In the area of banking reform, the NBP also tended to support the policies of the Polish governments. Under the administration of the Democratic Left Alliance and Polish Peasant Party, a government unwilling to promote foreign participation in the Polish banking system, the NBP cooperatively refused to grant banking licenses directly to foreign banks. Instead, foreign banks were able to obtain a license and access the Polish financial market by bailing out problematic banks (Polanski 1997: 68). Hanna Gronkiewicz-Waltz, who was then president of the NBP, supported bank consolidation promoted by the SLD-led Ministry of Finance instead of privatization to foreign investors (Epstein 2001). A significant change came in 1998 when Poland joined the OECD and signed an association agreement with the EU. The OECD explicitly called for limiting the power of the NBP to restrict sales of Polish banks to foreign strategic investors (Williamson 1999).

At the same time, the government made several attempts to limit NBP independence further, which caused numerous conflicts. One of the most high profile conflicts was fought between the SLD-PSL-led government and the NBP when Kolodko, Minister of Finance, criticized the central bank for its overly restrictive anti-inflation "crusade" and called for an interest rate reduction. In addition, the SLD-PS coalition requested legislation to create a separate institution for banking supervision and an NBP Council that would be responsible for monetary policy decisions rather than just having monetary power concentrated in the hands of one person, the NBP President. [624] According to this legislative proposal, the government and the Sejm

[624] Author's interview with Grzegorz Kolodko, former Minister of Finance (1994–1997 and 2002–2003), July 2 and 5, 2006, Warsaw.

would appoint three members each, while the Polish Union of Banks would appoint two. The president of NBP would also serve on the Council but he would be appointed by the prime minister instead of the president, making this appointment subject to greater political participation. In addition, the law would have allowed the central bank to lend the government up to 5 percent of the state budget. The Freedom Union, chaired by Balcerowicz, opposed this bill and submitted an alternative proposal on institutional reform at the NBP, which was ultimately passed under international pressures in 1997 (Epstein 2006).[625]

Ironically, the new NBP Act into the 1997 Polish Constitution strengthened, rather than weakened, the institutional independence of the central bank. It established a new NBP decision-making body, a 10-person Monetary Policy Council (*Rada Polityki Pieniężnej*, RPP) in 1998 (modeled on the *Banque de France*) in order to depolitize monetary policy making and to grant greater independence from the government to the central bank (Polanski 1998: 22). The members of the RPP have six-year terms, like the NBP president. While the Constitution defines the mission of the NBP in such broad terms as "responsibility for the value of Polish currency," it has also given the central bank "the exclusive right (…) to formulate and implement monetary policy (Article 227, paragraph 1). Significantly, the new law for the central bank has also eliminated the possibility of direct lending by the NBP to the government and has thus reduced the inflationary effects of fiscal policy.

A further strengthening of NBP independence was the outcome of its own initiative.[626] First, the two Polish economists, Jacek Rostowski and Andrzej

[625] Another object of contention between the NBP and the Ministry of Finance concerned the ownership by the NBP of three banks under recovery (Prosper Bank, Pierwszy Komercyjny Bank and Budbank) and the Polish Investment Bank until 1996 (Huterski, Nicholls and Wisniewski 2004: 206).

[626] The following discussion is based on author's interview with Marek Dabrowski, former First Deputy Minister of Finance (1989–1990), Member of Parliament (1991–1993), and Member of the Monetary Policy Council of the NBP (1998–2004), July 3, 2006, Warsaw.

Bratkowski (who became the NBP Deputy President) (2002), popularized the idea of unilateral *euroization* prior to the official entry of Poland into the euro zone. The main reasoning behind this policy option was that soft pegs pursued to promote national competitiveness represented an "inflationary *perpetum mobile*," reducing the NBP's control over money supply and inflation throughout the 1990s.[627] In contrast, unilateral *euroization*, which can conceptually be treated as an anti-inflationary strategy akin to a hard peg, would have a dampening effect on inflation and could play a disciplinary role for fiscal prudence. However, this idea did not find support among the domestic political elite and was strongly opposed by the European Commission.

Subsequently, a member of the new RPP, Boguslaw Grabowski, brought up the idea of inflation targeting as an alternative monetary policy in summer 1998.[628] The NBP announced the inflation targeting strategy in September 1998 and released the document "Medium-term Strategy of Monetary Policy (1999–2003)", which outlines the details of new policies and sets the inflation target at a level below 4 percent by the end of 2003 (table 8.3). The NBP also allowed the Polish zloty to move within a wide plus or minus 15 percent band. However, a crawling peg, which was still maintained, made the objective of monetary policy ambiguous, since price stability could still conflict with external competitiveness. The NBP stopped intervening on the foreign exchange market since July 1998. Nonetheless, because inflation targeting was in the hands of the NBP and the exchange rate remained co-determined by the central bank and the Council of Ministers, the adoption of float that

[627] Author's interview with Marek Dabrowski, former First Deputy Minister of Finance (1989–1990), Member of Parliament (1991–1993), and Member of the Monetary Policy Council of the NBP (1998–2004), July 3, 2006, Warsaw.

[628] Author's interview with Boguslaw Grabowski, Member of the Monetary Policy Council of the NBP (1998-2004), July 17, 2006, Warsaw.

would accompany a new monetary strategy of inflation targeting was delayed.[629] Finally, the decision was taken to replace the crawling system with a pure float of the Polish zloty in April 2000.

Table 8.3:Evolution of Inflation Targeting

Direct Inflation Targeting (DIT) adoption date	January 1999
Type of DIT	Initial: Strict; Present: Strict
Intermediate target level	Initial year: 6.6%–7.8% (Dec 1999); Present: 2.5%, ±1% band
Actual realization	Initial year: 9.8% (Dec 1999); Present: 2.2%
Corresponding exchange rate regime	Initial: Crawling band; Present: Pure float, as of April 2000
Target announcements	RPP of NBP

Source: Adapted from Orlowski (2008: 445–446).

The move towards inflation targeting combined with a full float left much less room for a government maneuver. The only person who voted against a full float was NBP governor Gronkiewicz-Waltz, who expressed concerns about inflation stabilization under a floating regime.[630] According to the 1997 central bank law, exchange rate policy is still determined by the Council of Ministers and the RPP approves the rules setting the exchange rate for the zloty along with implementing policy. However, because exchange rate policy is not a policy parameter in the new monetary framework, the central bank strengthened its independence further. The institutional strengthening of the NBP's independence enhanced the credibility of the

[629] Author's interview with Jerzy Pruski, First Deputy Governor of the NBP, July 12, 2006, Warsaw.
[630] Some members of the RPP, however, wanted to continue to intervene in the foreign exchange market. Author's interview with Krzysztof Rybinski, Deputy President of the NBP, July 5, 2006, Warsaw.

new monetary strategy compared with the previous one, which encouraged the government to fuel inflation (Lyziak, Mackiewicz, and Stanislawska 2007: 71).

Another major legislative change decreased the scope for central bank action, however. The new legislation entrusted banking supervision tasks to the Banking Supervision Commission, which is organizationally independent of the NBP. This solution can make banking supervision vulnerable to political influence via the Commission's representatives. Thus, it might negatively influence the independence of the central bank because it becomes more difficult to coordinate banking supervision with monetary policy.

Even though they were mostly unsuccessful, there were attempts to limit NBP independence after 1997. The Polish government continued to call on the central bank to lower interest rates in order to boost domestic exports. The most recent failed effort to limit the powers of the NBP was in 2002, when a group of parliamentarians from PS and the Labour Union proposed a bill to increase the number of RPPs from 10 to 16. New members would be elected by the Sejm, the Senate, and the President. Conversely, the SLD suggested that the government should set monetary policy, with the Monetary Policy Council merely in an advisory role (Kosc 2002).

Notwithstanding, the inflation target replaced the currency peg as the policy disciplinary anchor and provided an effective tool to combat inflation. In both Poland and the Czech Republic, inflation targets are announced and adopted by the central banks, allowing them to assume sole responsibility for inflation (Krzak and Ettl 1999). As a result of the monetary policy conducted between 1998 and 2002, inflation came down from 13.3 percent in December 1997 to 0.8 percent in December 2002 (Pruski and Szpunar 2005).

Conclusion

The political economic history of Polish exchange rate policy highlights the ways in which Polish policymakers' preferences for exchange rate stability and competitive valuation of the Polish zloty have competed with others' preferences for price stability. During the 1990s, exchange rate policy was an integral part of a national strategy of export-stimulated industrial development and economic growth.[631] Nonetheless, Polish policymakers never actively promoted competitive devaluations of the Polish zloty in nominal terms, and thus did not practice "beggar-thy-neighbor" tactics.

A successful financial reform and privatization with the participation of foreign strategic investors weakened the political influence of incumbent banks, as the outsider financiers brought with them more competition and stronger bank regulatory and supervisory institutions. In contrast to the Czech Republic, where the government allowed shares in major SOBs to be included in voucher privatization, in Poland, banks were reserved for conventional privatization methods of direct sales. From the beginning of the transition, Polish enterprises and banks were facing hard fiscal budgeting as well as credit constraints. The government approach to bad enterprise loans was to let banks to solve their bad loan problems with their debtors, and to focus on simultaneous bank and enterprise restructuring, as well as a gradual redefinition of property rights. Against the background of privatizing SOBs and the entrance of foreign banks in the Polish financial system, banks were forced early on to compete with each other. These initiatives had a positive long term impact on banking behavior and helped banks to change their heretofore incestuous relationships with incumbent enterprises. Thus, the Polish approach to financial reform created an institutional

[631] In contrast to three other cases under close examination in this study, Poland is not a very open economy. In 1999, its exports amounted only to 17.6 percent of GDP, while the overall trade was at 47.5 percent.

environment for a consensual policy making via deliberations that occurred not only between the government, the central bank, and commercial banks, but also between banks and industrial enterprises, their debtors. This institutional framework created favorable conditions for the competitively oriented exchange rate policy without big turbulences, costly devaluations, and financial crises.

The Polish central bank, which did not enjoy the same degree of independence as its Czech or Estonian counterparts, shared the authority over exchange rate policy with the government, and took a cooperative stance in working with the government. The Polish authorities used an array of instruments to support competitiveness of domestic industries including foreign exchange interventions, capital controls, and selective compensation of enterprises. In the late 1990s, the NBP, like its Czech counterpart, decided to adopt a new monetary strategy of inflation targeting that required a flexible exchange rate regime to obtain more independence from the government in pursuing an anti-inflationary monetary policy. Nonetheless, a consensual exchange rate policy in Poland aimed at disinflation yet simultaneously promoting national competitiveness would not have been possible without an open, stable, and well-regulated financial system.

CHAPTER 9

CONCLUDING THOUGHTS

Argument and Evidence

This study is motivated by the empirical observation of exchange rate regime heterogeneity in post-communist EE. It has sought to elucidate the pivotal role of financial institutions in the choice and sustainability of exchange rate regimes. In this concluding chapter, I start by summarizing the main argument and the evidence I have offered in support of the argument. Next, I propose the extension of the model at hand by exploring the political reasons and conditions behind the choice of privatizing SOBs and opening financial systems to foreign bank entry. Then, I address the ramifications of the argument at hand for the development of theory in political economy and examine the policy implications of the argument and the findings. I close this chapter by proposing future research directions.

This dissertation has pursued two broad lines of theoretical inquiry. In the preceding chapters, I have put forward a theoretical agenda to advance a finance-based theory that links financial institutions to exchange rate policies, and I have examined the primary hypothesis against a variety of empirical evidence. The principal hypothesis of this study is that in countries with financial systems dominated by SOBs, accompanied by weak monetary and regulatory institutions, their governments will lack the political support, willingness, and credibility to commit to and to sustain a fixed exchange rate regime. The likelihood of a country pursuing a fixed exchange rate regime will be higher in systems with a greater presence of foreign and private banks in national systems of finance. The finance-based theory is best conceived as a structural constraint on state behavior. The ownership and institutional structures of

financial systems mediate political preferences and power of different types of financiers and policy responses of governments to their demands.

I also argued that the connection between financial interests and exchange rate policies are mediated by financial institutional structures of financial governance. Understanding the determinants of exchange rate policies required research into the financial development in EE states. The second line of investigation, conducted in chapter 3 and in the case chapters, has explored the effects of privatization and financial openness on development of financial systems in EE states.

To analyze the plausibility of the finance-based hypothesis, I examined a variety of evidence. I began by carrying out econometric analyses of the primary hypothesis against quantitative data from 25 countries over the 15-year period between 1990 and 2004. To test the argument, I used a new measure of financial development incorporating the ownership structure as well as institutional features of the banking system. I then tested my hypothesis using logistic models on panel data. I also devised a new instrument for financial development that captures the mode of state asset divestiture, which I then used in applying an instrumental variable approach to address the question of endogeneity and causality in my models of exchange rate determination. The hypotheses were tested against the predominant explanations for exchange rate regime determination, including optimum currency area theory, financial dollarization, capital mobility, central bank independence, sectoral interests, and political regime. The tests are fairly robust to different measures of financial development, model specifications, and estimation methods. Results from these econometric analyses demonstrate that the finance-based hypothesis derived from the theory contribute to explaining the probability that a country will pursue a de facto fixed exchange rate in any given year.

Then, I explored the consistency of the general argument in chapter 5 by tracing the links between financial liberalization and exchange rate policies and exploring changes (voluntary and forced) in all EE states during different stages of post-communist transformation. The comparative analysis shows that the differences in the ability of governments to commit to and sustain a fixed regime reflect the variation in the determination of EE governments to cut ties with financial and industrial incumbents and to pursue financial openness and disinflation, to establish independent central banks and effective regulatory institutions, and to implement budget discipline. Those societies where governments were reluctant to liberate themselves from the influence of incumbent rent-seeking financial and industrial interests from the pre-communist era were unable to sustain currency pegs. Even when they officially announced pegs, they frequently reneged on their commitments to fixed regimes and pursued de facto flexible regimes. Chapter 5 explores and illustrates these discrepancies between official and actual exchange rate policies in EE states. Finally, I examined the specific process and mechanism that link financial institutions and exchange rate policies by conducting detailed analyses of four states—Bulgaria, Estonia, the Czech Republic and Poland—in chapters 6–8. The cases also provided strong support for the principal hypothesis. In the next section, I revisited the country histories in light of questions about distributional issues.

In sum, the combination of several models of inquiry in this study mean that they work with one another's deficiencies and make the research rigorous, testable, and generalizable. Statistical analysis can establish the empirical validity of the assumptions, but without contextual knowledge, it may miss key causal variables, which can result in unreliable conclusions. Qualitative analysis can generate a case for causation in a few cases by tracing the causal processes, but it is difficult to establish the generality of its conclusions or to falsify hypotheses.

Distributional Consequences of Exchange Rate Policies

While this study puts stress on the impact of financial institutional structures on exchange rate policies, to understand the economic policy choices of individual countries, it is important to evaluate the distributional consequences of these policies. Governments often do not act as benevolent social planners trying to find the best exchange rate policy for the society as a whole, but they try to accommodate preferences of different societal groups. As the case studies revealed, the choices of national exchange rate policy were the outcomes of a political process with important domestic distributional consequences.

The dual role of the exchange rate emphasizes the distributional consequences of different exchange rate policies. First, the nominal anchor approach underlines the role of the exchange rate in the inflationary process and its relationship with the functioning of the financial system, interest rates, and capital flows. The second is the real exchange rate approach that underlines the differences between tradable and nontradable goods, and the effect of the exchange rate on external competitiveness and the balance of payments (Bonilla and Schamis 2001: 66). Under a flexible regime, monetary expansion has its effect mostly through a depreciation of the currency that stimulates net foreign demand.[632] Thus, the choice between fixed and flexible regime is a choice between inflation and current account, and therefore a choice between benefits to special interest groups against costs to the general public (Stein and Strebb 1999). This trade-off is particularly relevant in transition states, where inflation has been a persistent problem.

Although this research has been empirical in its focus, analyzing why governments choose and sustain a fixed exchange rate regime when they do, I have

[632] A currency float supplements the traditional channel used to stimulate domestic demand via decreasing real interest rate (Frankel 1995: 38).

granted that fixed regimes help the governments to curb inflation, which represented the principal problem of transition throughout the 1990s. The politics of inflation with its distributional consequences occupied center stage during the post-communist transformation. Fixed exchange rates do generate an economic benefit of low inflation but not without imposing costs. Whether the benefit of price stability is "worth" the cost is an inherently political question (Clark 2003). As Kirshner (2001: 42) argues, "Inflation is always and everywhere a political phenomenon. All levels of inflation, high and low, are the outcome of political conflicts."

In Bulgaria, inflation served as the major redistributive tool during the pre-1997 period.[633] Debtors with debt in domestic currency favored a flexible regime, for they benefited from devaluations that resulted in high inflation. High inflation depreciated and reduced the real cost of servicing the debt of the coalition of debtors—capturers of the government and the central bank. The debtor group was composed of incumbent political elites, the subsidized state-owned enterprises and refinanced SOBs, crony private banks and enterprises. The Bulgarian central bank served as a "transmission mechanism" of wealth to the debtors: it had repeatedly refinanced distressed bank assets and extended massive loans to banks and to the government, which produced hyperinflation, one negative consequence. The general population, the main creditor, was the net saver and its savings in the form of deposits and government securities systematically depreciated. So, the taxpayers were against high inflation and flexible regime because they were losing money. During the pre-crisis period in Bulgaria, from a redistribution perspective, the debtor group dominated over the creditor group (Nenovsky and Mihaylova 2007). The politics of redistribution then turned into the politics of hyperinflation, in response to which a political coalition

[633] Author's interview with Georgy Ganev, Program Director for Economic Research, Center for Liberal Studies, June 29, 2007, Sofia.

favoring price and exchange rate stability emerged and implemented a currency board in 1997.

Unlike Bulgaria, the Estonian government was determined from the outset of the transition to prevent the arbitrary redistribution of wealth that accompanied the initial inflation. A precondition was an open competitive financial system and an independent central bank able to keep incumbent banks and enterprises in check to curb inflation. The coalition in favor of low inflation enjoyed broad support. Exchange rate stability became associated with price stability in the public mind. The currency board (CB) promised that it would quickly bring credibility to monetary policy by tying the hands of policymakers to attain two principal objectives: disinflation and stable exchange rates. The currency board was also an institutional way to curb the BOE's discretionary power, which has later emerged as a strong regulatory force of banks. This institutional arrangement eliminated discretion in the management of the exchange rate and limited the use of discretionary monetary policy to accommodate distributional conflicts. In the distributional game of economic and financial reforms in Estonia, foreign investors and private entrepreneurs were the main winners, relatively, while incumbent interests, members of the Party nomenklatura and farmers were the losers (Ennuste et al. 2004: 12).

In the Czech Republic, a distributional coalition led by SOBs and their investment funds, protected by the state, became the main beneficiaries in the distributional game. The institutional logic of banking socialism based on the collusion among incumbent banks, industries, and the state facilitated the redistribution through preferential allocation of credit, subsidies, loan forgiveness, and bailouts to incumbent enterprises via SOBs. The resulting debt burden of bad loans resulting from expansive credit policies was redistributed from banks back to the state, that is, taxpayers. The pattern of currency turmoil in 1997 was the inconsistency

between the central bank policy of the fixed exchange rate regime used as a nominal anchor to tame inflation and the government fiscal deficit resulting from subsidies and government bailouts in conditions of a liberalized capital account.

Finally, the Polish case illustrates the tradeoff between inflation and balance of payments. Early financial reforms and a fixed regime appeased distributional conflict and diminished its intensity. While farmers, government enterprises, and banks initially favored a reflationary agenda and a flexible regime, their political influence was neutralized through privatization and banking reforms early in the transition. Still, the central bank, dependent on the government as well as a joint decision-making of exchange rate policy between the central bank and other government ministries resulted in a consensus on subordinating domestic price stability to serve competitiveness of domestic industries through the policy of politicized soft pegs.[634] In sum, this study illustrates an approach based on a story of redistribution wherein those societal and political actors who favor low inflation, currency stability, and financial openness stand to win from fixed regimes, while those who favor national protection, economic closure, and reckless macroeconomic policies stand to lose. There are several lessons that can be drawn from these empirical observations from transition states. The first lesson is that an exclusive focus on exchange rate policy may miss other locations of political struggle, such as inflationary monetary policies, or expansive fiscal or credit policies, which influence exchange rate policies and have broad distributional consequences. Thus, research on interest groups in exchange rate policy should pay more attention to the ability of interest groups to engage in collective action to influence various macroeconomic policies that in turn affect exchange rate policies.

[634] Exchange rate supplements the traditional channel used to stimulate domestic demand via decreasing real interest rates (Frankel 1995: 38).

Second, the costs of financial repression in financial systems dominated by powerful incumbent financiers are usually borne by depositors who receive low or negative interest on their funds and by small enterprises that have limited access to credit, for credit is being extended to large government enterprises and rich individuals. In contrast, in open financial systems, healthy banks, backed by foreign parents, actively support the restructuring of privatized enterprises, grant loans to small entrepreneurs and finance mortgages of people to buy homes.

Third, during the banking financial crises, there had been massive redistributions from ordinary taxpayers to the financial sector. The fiscal and quasi-fiscal costs of the banking crises during the 1990s (including bank restructuring and deposit compensation) ranged from 7 to 42 percent of the output for the Central European countries, from 0.1 to 18 percent of output for the CIS countries, and from 2 to 3 percent of the output for the Baltic countries (Tang et al. 2000). In most CIS countries, enterprises, banks, and depositors were left exposed rather than bailed out through recapitalization (Sherif et al. 2003: 71). The 2008 global financial crisis has also inflicted a sharp contraction in economic fortunes and major cutbacks in employment in many transition economies.

Extension of the Argument: Why Do Countries Privatize Banks?

In this section, I extend the model at hand by going one step back in the causal chain to explore two interconnected questions: first, why governments do (or do not) privatize SOBs;[635] and second, why they open their domestic banking sectors to foreign buyouts.

[635] For an excellent volume examining the rationale and performance of SOBs as well as policies that governments take to privatize them or to manage them, see Caprio et al. (2004).

Different economic and political motivations drive policy decisions of governments regarding SOBs. Policy makers may apply a cost-benefit calculation and privatize SOBs when the costs of state ownership exceed the benefits of the possibility to reward favored clients or to provide employment (Caprio et al. 2004: 31).[636] Governments might also choose to privatize because they believe in the effectiveness of privatization based on observed experience or imitation of successful privatization policies in peer countries (Meseguer 2005).

The economic calculus must be adjusted, however, to account for political support for the privatization of SOBs. As I have illustrated in case studies, the decision on whether to liberalize and privatize or not, and what method of privatizing to use, can be influenced by interest groups because privatization has important economic impacts on these groups. Privatization, in turn, is one of the channels through which interest groups can indirectly influence financial development (Ben-David 2003). As all four cases under close examination in this study illustrate, in the initial stages of transition, incumbent financiers wanted to continue holding assets under controllable government bank ownership, instead of allowing a hostile takeover, particularly by foreign banks. Incumbent SOBs operating with high costs and low productivity wanted to prevent the entry of foreign banks, which were significantly more competitive. Incumbent industrialists, their clients, who received privileged access to credit, were also strong opponents of financial liberalization. In Russia, incumbent banks not only did not support privatization in the banking sector, but also, some even lobbied for the strengthening of the state's links via renationalization and for greater

[636] According to the 1998 OECD Report (1998: 14), governments usually favor bank privatization out of a conviction that, first, private enterprises are more efficient and competitive in global markets than are state-owned enterprises; second, privatization will foster the development of a healthy banking system, and capital flows accompanying privatization can spur the development of capital markets; and, finally, privatization will improve a country's fiscal balances given the cost of serial recapitalizations of insolvent SOBs.

state support of industries—their clients and often shareholders—in the form of tax and custom breaks (Tompson 1997: 1172). On the other hand, the approach of Polish authorities to financial development based on openness to foreign bank entry resulted in a positive attitude of incumbent banks toward privatization by foreign investors in order to survive in a tough international competition.

Trade unions represent another interest group that can influence government privatization decisions. Pagano and Volpin (2005) showed that in their effort to avoid takeovers, enterprise managers and trade unions join forces in order to restrict investor rights and secure their own employment. Incumbent managers want to provide employees with long-term contracts to make enterprises unattractive to potential buyers. While Podkrepa, the largest trade union in Bulgaria was an important factor behind delayed privatization of banks and industries through its strong influence on the right-wing UDF coalition, the Czech and Estonian trade unions had little impact on different privatization decisions adopted by right-wing governments in these two countries. The Czech and Slovak Confederation of Trade Unions, the major trade union in the former Czechoslovakia, made unsuccessful efforts to augment ownership share for employees in privatized enterprises (Appel 2004: 137). Trade unions, seen as a remnant of the political past, were weakened by anti-communist feelings in the post-communist Czech Republic (Appel 2000: 530–532). In Poland, the political process at the outset of the transition was dominated by Solidarity and the Polish Confederation of Trade Unions, which were strongly aligned to the political parties that adopted radical reform programs and promoted privatization (Shields 2004). Although Polish trade unions remained the most influential in the region, with the progress of privatization and the rise of unemployment, their role has significantly diminished over time (Kochanowicz, Kozarzewski, and Woodward 2003).

Various political incentives may also influence government decisions to protect domestic banking sectors from foreign ownership. In financially repressed systems, populism, nationalism, and *statism* may play a significant role in the government approach to the banking sector (Caprio et al. 2001: 4–5). Populist and nationalist agendas of the Czech governments prior to the financial turmoil in 1997 included the objective of impeding the control of the domestic financial system by foreigners. The successive Klaus centre-right governments in the Czech Republic as well as the Socialist government in Poland that came to power in 1993 wanted to create "national champions" and maintain domestic control of large financial institutions. Protectionist governments are reluctant to liberalize domestic finance because they want to use state interventions in the financial sector and direct credit to "priority sectors" such as agriculture, small enterprises, exporters and failing enterprises to improve the allocation of funds and to prevent unemployment.[637] Sales to foreign strategic investors also carry political risks that governments have "sold out" (Caprio et al. 2004).

The spread of privatization (and liberalization) in the financial sector in EE has been also attributed to the conditionality attached to IMF, World Bank, or EBRD lending for the purpose of recapitalizing and privatizing banks. International pressures, however, appear to be a factor in privatization design in some countries but not in others. International institutions seemed to have an important influence on the decision of the Polish Socialist government to resume the privatization of banks to foreign investors in 1996 after it tried to postpone it temporarily. On the other hand, while the conditions of the IMF programs in Bulgaria included bank privatization and a

[637] Wyplosz (2001) showed how governments in post-war Belgium, France, and Italy supported favored industries, regions, and enterprises through interest rates and other controls that fueled inflation, repeated devaluations, and the exchange rate crises of 1983, prompting a political reassessment and radical changes in the governmental approach to the financial sector.

comprehensive system of prudential banking regulations, successive Bulgarian governments fell behind those conditions until the country was hit by a systemic banking and financial crisis in 1996–1997. The IMF, in its efforts to promote bank privatization, has been often considered by borrowing countries to represent the interests of foreign creditors (Nenovsky and Rizopoulos 2003: 918). The Czech government implemented voucher privatization of banks and industries that led to the preservation of state ownership, in spite of disapproval by the World Bank. Similarly, despite strong EU pressures to privatize two of the country's largest SOBs by December of 2000, the Slovenian government was reluctant to sell its domestic banks to foreigners, and by 2001, it still owned nearly 90 percent of the banking sector (Lindstrom 2005).[638] In sum, in spite of international pressures, EE governments seem to have enjoyed considerable room for maneuvering in bank-privatization policies.

Besides economic nationalism, there are also economic arguments in favor of maintaining domestic control over banks. Domestic banks usually establish a longer-term relationship with domestic industries, and they tend to provide more consistent financing of domestic exporters and importers. Domestic banks are also more susceptible to moral suasion of the government to lend to domestic rather than to foreign enterprises, which would be rather insensitive to long-term national goals. Finally, government reluctance to sell domestic banks to foreigners can be motivated by their fear that in the long run, the domestic economy will become merely a "branch plant" for big international banks (Porter 1998: 20).[639]

[638] The EU requires from its member and acceding countries the alignment of their financial regulations with the Banking Law and Financial Stability Law of 1999.

[639] These concerns have been reinforced in some post-colonial countries by a resentment of foreign-owned banks, which were viewed as representing the economic interests of their shareholders and large multinational clients at the expense of domestic enterprises (Andrews 2005).

Another lesson from the case studies examined here is that governments have shown a greater propensity for privatizing banks after systemic banking and financial crises, which also reinforce the view that SOBs have a negative influence on financial stability and economic growth. The crises themselves usually have large and visible fiscal effects and undermine the credibility of incumbent constituencies. When the fiscal costs of banking crises are high, the political cost of maintaining state ownership can outweigh the benefits, and governments may be inclined to privatize, particularly to a foreign strategic investor, in order to prevent the use of public funds for bailouts of SOBs (Andrews 2005: 15). Moreover, countries in crisis are often in greater need of international mobile capital as a result of their pre-crisis budgetary and balance-of-payments imbalances (Haggard and Maxfield 1996). Thus, banking and financial crises presented the EE governments with unique opportunities to change policies that were hard to implement in normal times.

Theoretical Implications

From the standpoint of theory, this research has implications for different strands of political economy literature, notably the literature on the political economy of international finance, the debate on the development of financial systems, and the literature on the post-communist transitions.

This study holds considerable significance for the literature on the political economy of international finance. The findings of this study expand our understanding of the workings of interest-group politics by illuminating the role of financial interests in exchange rate but also in monetary and regulatory policies. The main contribution of this study is that it does not treat financiers as a homogeneous societal group but argues that their interests and behavior in exchange rate, regulatory, and monetary policies are differentiated by the nature of their ownership—government, private

domestic, and foreign. I show that in contrast to standard expectations about the interests of banks, both commercial and central, in maintaining low inflation and stable currency, banks can support inflationary policies, engage in reckless risk-taking with other people's money, and facilitate capital flight in transitional institutional environments. Although the primary interest of banks—profit maximization—is fixed, bank strategies, behavior and coalitions reflect the nature of their ownership and changes in specifics of the institutional environment.

This research also helps to identify institutional structures of finance, in which financiers are the engines of economic growth as well as those systems, in which they become vested interests that contribute to unsustainable exchange rate policies, and thus impede economic development. As an interest group, banks can also enhance democratic politics inasmuch as democracy provides them with a formal means of participation in the political system through well-established channels of interest group representation and lobbying that would increase the group's support for democratic institutions. However, as illustrated in this study, if banks use their power to extract excessive resources from the state to the detriment of the general population through their personalistic contacts with the political elite, this type of interest group behavior is antithetical to democratic politics and responsible money management. Here, my theory also addresses the debate on "state strength." Here, a strong state is one with a bureaucratic apparatus capable of regulating and monitoring banks and their business clients.

In addition, this research contributes to the study of financial liberalization. In contrast to most analyses solely examining capital account liberalization, this study focuses on the liberalization of the domestic financial sector. While capital account liberalization may be the most visible element, its significance cannot be fully assessed apart from domestic financial reforms, for two main reasons: first, the

financial sector has a broad economic impact, and it can mobilize a wide range of political actors and interest groups, and second, banking regulations strongly affect international capital movements (Horowitz 2005: 112).[640] This study highlights the importance of liberalizing domestic finance, which is a precondition for the financial integration of transition and emerging-market economies into global financial markets.[641]

While the benefits of the liberalization of capital movements are still hotly debated, there is more agreement on the positive effects of financial sector liberalization.[642] Bekaert et al. (cited in Detragiache et al. 2006: 4) found that financial liberalization, in the sense of opening the stock market to foreign investors, can increase economic growth by as much as 1 percent per year. Nonetheless, the liberalization of the financial sector can contribute to macroeconomic instability and lead to financial crises. Kaminsky and Reinhart (1999) showed that 18 out of 26 financial crises in the past twenty years occurred after financial sector was liberalized within the preceding five years. Countries that allow foreign banks to enter their financial markets are often affected by the performance of these banks in other countries. Losses that European banks made on American mortgage products, for instance, may cause tighter credit in some EE states.

A second theoretical implication addresses the literature on financial development, surveyed in chapter 3. While most of this literature considers only the

[640] Despite numerous studies on the topic, the benefits of the liberalization of capital movements are still strongly debated and a consensus view has not yet emerged (Mishkin 2006, Eichengreen and Leblang 2002).

[641] By 2007, almost 900 foreign banks had a presence in developing countries. On average, they accounted for 40 percent of bank lending, up from 20 percent a decade earlier. See "Charting a different course." *When fortune frowned: A special report on the world economy*, October 11.

[642] For a comprehensive chronology of financial liberalization (liberalization of capital accounts, of the domestic financial system, and of domestic stock markets) in developed and emerging economies since 1973, see Kaminsky and Schmukler (2003).

impact of various economic and political factors on financial development or the effects of financial development on economic growth, this study sets out to assess systematically how different financial institutional structures impact macroeconomic policies. Therefore, it speaks to the debates in the new institutionalist literature that emphasizes the primacy of institutions in economic policies (Acemoglu, et al. 2001).

A third theoretical implication speaks to the studies done on the processes of building fundamental market institutions in countries experiencing economic and political transformations. There is a growing literature that explores the role of various factors in producing divergent financial systems in EE that include Soviet-era institutional legacies, varying political and economic policy approaches to post-communist transformation, electoral competition, and exposures to international institutions (Neumann and Egan 1999, Johnson 2000, 2005, Epstein 2001, 2006, McDermott 2006, Lindstrom 2005, Denizer et al. 2006). Although bank privatization has been an essential part of financial reform agendas in transition countries, studies exploring the role of bank privatization are scarce, and most of them focus on its effects on bank performance and efficiency (Bonin et al. 1998 and 2004). Some scholars have explored the impact of the chosen model of enterprise privatization in explaining financial system development in the post-communist region (Popov 1999). More generally, scholars have investigated the role of initial conditions, political institutions, and strategies that arose in the course of transition, in explaining divergent outcomes in the post-communist world (Darden and Grzymala-Busse 2006, de Melo et al, 2001, Hellman 1998, Bunce 1999 and 2000, Fish 1998). This is the first study that systematically examines the differences between the emerging models of financial governance in the post-communist region of EE.[643]

[643] Edited volumes dealing with various aspects of financial reforms focusing on specific country experiences burgeon, though. See Blejer and Škreb (1999), Dickinson and Mullineux (2001), Colombo and Driffill (2003).

Policy Implications

I believe that social science should inform public policy debates. Beyond scholarly implications, my own reading of the evidence suggests that a broader societal impact of this project lies in two broad areas.

This study should prove helpful in determining *a priori* a country's vulnerabilities in adopting a fixed regime and identify the cases where this would be a sustainable policy choice. A better understanding of financial institutional structures that allow sustaining a fixed regime should allow policymakers to make a more informed decision about when it is most advisable to adopt and pursue this policy. This research can be useful in predicting exchange rate regimes in countries that try to combat high inflation and stabilize their economies or for those EE states preparing for entry into the EMU. As explained in chapter 1, I do not examine which regime is better for an economy, but the empirical evidence provided in this study does support the argument that a fixed regime helped to stabilize economies left with high inflation after the collapse of Soviet planning and has been a good way of keeping on track for eventual membership in the euro zone. But there are those who argue that to deal with volatility of foreign capital, greater currency flexibility may be desirable in transition and emerging states. When a country is hit by a crisis and outsiders suddenly pull money out of a country with a pegged currency, the money supply decreases, and the country risks a depression. While a fixed exchange rate regime limits room to maneuver, a country with a flexible regime can try to restore competitiveness of domestic exporters and growth by devaluing the currency. However, in the context of the 2008 financial overhaul, in the EE countries with flexible regimes, the low level of global demand has severely limited the supply response to the currency depreciations

in the region.[644] Therefore, researchers have not demonstrated the case for a fixed or a flexible regime and growth. The contention in this study is that politics, through the strength of financiers, influence the determination of exchange rate regime.

The theory of exchange rate choice and sustainability developed in this study is not general to all circumstances and contexts. But no theory can be universal. My theory has been generated and tested on the sample of transition economies and it should travel well to other emerging markets. It has been argued that the 2008 U.S. financial crisis is very similar to the financial crisis in Russia and other transition countries, both in what led to the crisis and how to fix it, so we can extract several useful lessons from this study for developed countries, as well.

Much like incumbent banks and the "oligarchs" did in Russia and other EE states, financiers played the main role in creating the current financial crisis in the United States, taking ever-greater risks with the implicit backing of the government. The United States has created a system whereby the Wall Street "oligarchs" have monopolized the economy. The great wealth that the financial sector amassed and concentrated gave financiers enormous political weight, for the banking and securities industry has become one of the top contributors to political campaigns (Johnson 2009a, Desmond 2009, Summers 2008).

At first sight, it seems that the current U.S. financial crisis poses a challenge to the finance-based theory advanced in this study, for the Anglo-Saxon brand of finance is home to the world's most advanced financial system and vanguard of open finance and free-market capitalism dominated by private rather than government banks. But the Anglo-Saxon system is capital-based unlike more traditional bank-dominated systems in EE states. In fact, the epicenter of the current financial crisis is not traditional commercial banks, but bank-like institutions referred to as the "shadow

[644] See "Financial Sector Key to European Recovery." 2009. *IMF Survey Magazine*, April 24.

banking system"—money-market funds, securities dealers, hedge funds, and other non-bank financial institutions—that operated outside the regulatory system grew rapidly even to surpass conventional banking in importance and made various risky cross-border investments. Traditional private domestic banks, which take deposits and grant loans, are part of the Federal Reserve system and are highly regulated (Krugman 2009: 153–165).

Still, long before they were formally taken, the two private mortgage companies, Fannie Mae and Freddie Mac, had implicit government guarantees. As Calomiris and Wallison noted, one reason the market for subprime mortgages exploded after 2004 was that these institutions started buying subprime mortgages because of a political order to expand the financing of "affordable housing."[645] Therefore, the first lesson from the transition economies should be about the dangers of government involvement in financial markets, through implicit guarantees of "private institutions," coupled with moral hazard and weak regulation that generate bad economic outcomes at the expense of taxpayers. This is also the lesson from the Fannie and Freddie failure. As a result of the U.S. government bailout, financial system is currently nominally in private hands but is able to tap the state for support. Johnson and Kwak (2009) argue that these state backed banks operate for the benefit of bankers and their creditors, and the situation is characterized by "public-private co-dependency."

In spite of similarities, the significant difference between the current U.S. and transition and emerging market crises in the past is the exchange rate. Post-crisis booms are often triggered by large nominal exchange rate depreciations, making exports competitive and starting a new cycle of capital flows. The dollar is, however,

[645] Calomiris and Wallison quoted in "Taming the beast: How far should finance be re-regulated?" 2008. When fortune frowned: Special report on the world economy. *The Economist*, October 11.

the world's reserve currency and significant real depreciation is not very likely (Johnson 2009b).

A second and related lesson from this study is that in the world of liberalized capital flows, a well-regulated domestic financial system is crucial for sustainable exchange rates and preventing financial crises. The key policy decisions of the U.S. government were to deregulate commissions for stock trading in the 1970s and to eliminate the Glass-Steagall restrictions on mixing commercial and investment banking in the 1990s, allowing commercial banks to engage in the traditional operations of investment banks. The latter, which were driven into riskier activities by these policy changes, were entirely outside the regulatory framework (Eichengreen 2008). As stated above, the U.S. crisis involved for the most part risks taken by the institutions of the shadow banking system that were never regulated in the first place and not the problems with deregulated institutions taking new risks, as the most recent Nobel laureate Paul Krugman (2009: 163) argues. The 1997 financial turmoil in the Czech Republic shares some similarities. Believing in free market capitalism and deregulation, the Czech governments were reluctant to regulate investment privatization funds and loan insider lending as well as to adopt regulation in the area of bankruptcy proceedings, which created financial vulnerabilities that led to the banking and financial crisis.

The third lesson is that although funding from foreign banks to sustain local credit booms are blamed for EE states having been affected by the financial crisis, these banks act as a strong stabilizing force and play a vital role in preventing "hard landing" of the region. Foreign parent banks are currently facing several challenges including their own difficult funding conditions, expected increase of bad loans in EE due to worsening economic conditions, deteriorating economic situation in home countries of parent banks, and exposure to depreciating currencies in some EE states

due to high levels of foreign currency lending (Stokes 2009). Thus, some distressed foreign banks have reduced lending and stopped issuing mortgages in foreign currency. Foreign banks are also associated with the risk that the financial crisis will be spread through the "common lender" channel: through its loan portfolio a bank may be exposed to a country that has a financial crisis, triggering large capital outflows from other borrowers. For instance, the same Swedish banks that dominate Latvia's banking system also dominate those in Estonia and Lithuania, and thus a Latvian crisis can spill over to other two Baltic states through the Swedish parent banks (Stokes 2009). Nevertheless, just as the Baltic states are dependent on the health and strategy of Swedish banks, the banks depend on the performance of their Baltic subsidiaries. The Swedish government is aware that the situation in the Baltic states is crucial to the stability of the Swedish financial system, so it had been contributing large sums to international efforts to help the Baltic countries, not only to Swedish banks (Dougherty 2009). Similarly, foreign banks from other countries who dominated the region's banking systems have pledged to continue to support their EE subsidiaries (Stokes 2009).

The presence of foreign banks is fairly uncontroversial in most EE states. For instance, the Russian occupation of the Baltic states for much of the twentieth century makes the presence of Scandinavian banks seem rather benign (Dougherty 2009). Foreign banks are highly trusted institutions in EE. In some EE countries, as Krastev, a Sofia-based analyst argues, people trust foreign banks even more than any public institutions. Foreign banks have become the symbolic and financial linchpins not just of economies, but of whole countries.[646] Still, blaming economic hardship on foreign banks that have taken deposits but are unwilling to make loans can be a tempting slogan for populist politicians in EE.

[646] See "Who's next?" 2008. *The Economist*, October 23.

The fourth lesson that can be extracted from this study is that state ownership of banks often leads to financial instability. This is true even in advanced financial systems and German public banks, or Landesbanken, prove the case. The German government had to bail out Landesbanken with taxpayers' money after their managements recklessly gambled away billions on subprime investments. Political protection is characteristic for many Landesbanken, owned by state governments or local savings banks. These public sector banks speculated far more recklessly than private banks in American subprime mortgage securities did. In the end, the federal government and private banks had to bail them out to weather the global financial turmoil and stop them from collapsing. The bankruptcy of some of these banks would trigger an unprecedented loss of confidence in the German financial system (Reuter 2008).

One common method of dealing with banking crises is *nationalizing* private banks rather than letting them collapse. Because state ownership of banks is disappointing, there are good reasons to be skeptical about the recent wave of nationalization of financial institutions in the United States and Western Europe. Nationalization of bad banks also carries huge costs of its own. With the global financial system crowded with unwanted bank assets, it could take a long time for the government to privatize banks. Meanwhile, as the Czech cases illustrates, politicians would be tempted to use banks as instruments of industrial policy, supporting politically powerful enterprises. Politically motivated lending could result in even larger amounts of bad loans in the future and private banks would be disadvantaged.[647] Managing banks should not be the role for governments; politicians should be kept away from credit. As this study shows, once the allocation of loans becomes politicized, the outcome is financial fragility and high inflation because the central

[647] "Economics focus: The spectre of nationalization." 2009. *The Economist*, January 24-30: 82.

bank loses the ability to manage monetary policy. Corruption and government interference can destroy the foundations of even the most advanced financial systems, particularly when these problems are combined with weak regulatory institutions (Prasad 2009).

Fifth, the 2008 banking and financial crisis in Iceland confirms the argument made in this study that insider privatization results in a financial system that remains dominated by incumbent financiers that create financial vulnerabilities that make the financial crisis possible. For decades, the government of Iceland owned the banks, which exercised significant power with negative real interest rates and an overvalued currency. Iceland's privatization of its SOBs during 1998–2003 aimed to cut the links between banks and the government but it did not fully succeed. The two largest SOBs were sold to well-connected individuals with close ties to the two governing parties, which maintained their representatives on the banks' governing boards. No serious attempt was made to attract foreign buyers of banks as was done in the Baltic countries. Unlike the Baltic countries, there is as yet no foreign competition in Icelandic banking. Incumbent banks engaged in unprecedented borrowing and lending: they borrowed abroad at low interest to make long-term housing loans home at very low interest rates at home and engaged in extensive insider lending without adequate collateral. As a result, in September 2008, the three largest banks collapsed within a week and the Islandic króna depreciated by 50 percent. The Islandic government temporarily nationalized the old private banks based on a Nordic solution but has plans to re-privatize these new SOBs that took over deposits of old private banks and invite foreign ownership (Gylfason 2009).

Finally, this study shows that centralized asset-recovery schemes have a bad record.[648] In the Czech Republic, banks continued to make bad loans after their bad debt burdens were removed and placed in a state-owned "bank hospital" responsible for restructuring bad assets. This centralized solution to bad debt has proved to be prone to political misuse by a coalition of bankers, enterprises and government politicians at the expense of "Main Street." In contrast, the Polish decentralization scheme, in which banks and enterprises were expected to solve the problem of bad assets themselves, has proven effective in limiting moral hazard.

Paths for Future Research

This study lends itself to a number of different avenues for future research. I have already speculated on how we can extend the causal chain of exchange rate policy determination to explore the political reasons and conditions behind the choice of privatizing SOBs and letting foreign banks in. In closing, I raise two additional possibilities.

First, within the scope of this study, the present hypothesis generated in this study may be examined under other institutional contexts by conducting out-of-sample tests, while looking at a larger set of emerging market economies in Asia and Latin America, to increase the research's analytical range and empirical scope. Were I to find evidence consistent with my theoretical framework, these tests would further underscore the empirical robustness of the argument at hand.

[648] When a country is trying to reform a financial system plagued with a large portfolio of nonperforming loans, the government may close troubled banks and liquidate their property (appropriate mostly in the case of smaller banks); or it may relax regulatory restrictions, e.g., capital and reserve requirements, to facilitate the banks to solve their problems themselves when the economy recovers; or finally, it may fix the portfolio of banks through re-capitalization or providing liquidity to banks. In EE, recapitalization of state-owned banks was also often necessary before privatization to clean off the banks' balance sheets.

Second, another research possibility that captures the underlying theme of this study is the issue of sovereign wealth funds (SWFs) whose growing power in global finance has given rise to considerable political controversy. Governments establish SWFs, defined as government investment vehicles funded by foreign exchange assets, to manage their international investments, in addition to owning banks. SWFs, used by governments of developing and emerging countries to acquire strategic stakes in developed countries, often in a non-transparent way, are a graphic contemporary example of the controversial role of foreign investments.[649] The proposed research would represent a hard test of my argument on the positive effect of foreign ownership on a host country's macroeconomic policies and financial regulation. In contrast with foreign private banks examined in this study, SWFs are mostly state-owned, which raises the risk of moral hazard problems because governments may have political objectives over profit maximizing objectives. SWFs are predominantly based in the Middle East, South Asia, and EE; thus they play an important role in a reversal of global capital flows: capital increasingly flows from the periphery to the core countries (Lucas 1990). With respect to the management of SWFs, important issues of international financial stability and economic cooperation come into play, including maintaining the openness of economies and financial systems to cross-border investments. The rise of SWFs could provoke a new round of protectionism, in which Western governments erect barriers to foreign investment in what they consider to be strategic sectors in their economies.[650] Finally, foreign investment by SWFs raises national security concerns because the purpose of the investment may be to secure control of strategically important industries for political rather than for financial gains.

[649] Included among the big seven SWFs that have over $100 billion in assets are Abu Dhabi, Kuwait, China, and Russia.

[650] Dubai Ports World had to abandon their attempt to buy P&O's U.S. ports after a national security debate was prompted in the U.S. Congress.

There is still more to be done. We could delve still deeper into welfare implications of different exchange rate regimes. We might explore the implications of exchange rate policies in EE states for regional and international monetary and financial cooperation. But I leave these and other research questions for another day.

APPENDIX A

BANK PRIVATIZATION IN EASTERN EUROPE, 1990–2004

Country	*Bank*	*Year of Privatization*	*Method*	*Details*	*Strategic Owner*	*Market Share*
Albania	National Commercial Bank	2000		Privatization 06/2000. Value: US$10million.		
Albania	INSIG	2003		Proceeds: $11 million		
Albania						
Albania						
Bulgaria	United Bulgarian Bank	May 1997	Tender	65 % sold to Oppenheimer (US) and the EBRD.	7/2000	12.4 (2000)
Bulgaria	Bulgarian Post Bank	1998	Tender	78 % share sold.	11/1998	5.2 (2000)
Bulgaria	SG Express Bank	1999	Tender	67 % sold in 09/1999. Value: US$39.5 million.	11/1999	4.5 (2000)
Bulgaria	Bulbank	October 2000	Tender	98 % sold to a consortium of Unicredito (Italy) and Allianz (Germany).	10/2000	25.4 (2000)
Bulgaria	Derzhavna Spestovna Kassa (DSK Bank)	2003	Tender	100 % sold to OTP Bank (Hungary)	5/2003	12.1 (2000)
Bulgaria	Biochim Bank	October 2002			10/2002	5.3 (2000)
Bulgaria	Hebros Bank	1999		Privatized December 1999. Value: US$23.5million.	3/2000	3.4 (2000)
Croatia	Dubrovacka Bank	1994		Majority share sold to domestic investor, renationalized in 1998 due to distress.		
Croatia	Dubrovacka Bank	2002		Re-privatized in 2002. State-owned, acquired by Dalmatinska.		2.9 (2000)
Croatia	Privedna Banka Zagreb (PBZ)	1999		Domestic private. Nationalized in 1996, and then privatized.	12/1999	12.99 (2000)
Croatia	Rijecka Banka	2000		Domestic private. Renationalized in 1996, privatized 4/2000.	4/2000	7.0 (2000)

Country	*Bank*	*Year of Privatization*	*Method*	*Details*	*Strategic Owner*	*Market Share*
Croatia	Splitska Banka	2000		Domestic private. Nationalized 1996. Privatized 5/2000.	5/2000	7.1 (2000)
Croatia	Zagrabacka Banka	1996	IPO	Domestic private. IPO June 1996. Shares sold 12/99.	3/2002	28.9 (2000)
Croatia	Varazdinska Banka	2000		Domestic private. Acquired by Zagrabacka banka 6/00.		2.6 (2000)
Croatia	Dalmatinska Banka	2000		Domestic private.	10/2000	2.3 (2000)
Czech Republic	Komerční Banka	1992	IPO	Voucher privatization 12/92. 21 % sold through IPO in November 1994, subsequent exchange offerings of 3 % in 1995 and 1996. Government retained majority stake until June 2001 when government sold 60 % to Societé Générale.	6/2001	18.4 (06/2001)
Czech Republic	Česká Spořitelna	2000		Voucher privatization 12/1992	2/2000	15.7 (06/2001)
Czech Republic	Investiční a Poštovní Banka (IPB)	1992		Voucher privatization 12/92. Sold to Nomura Investments, performed poorly and subsequently renationalized. Merged with CSOB 6/2000.	3/1998	Part of CSOB
Czech Republic	Československá obchodní banka (ČSOB)	1999		Privatized 9/99. Merged with IPB 6/2000.	9/1999	21.4 (06/2001)
Czech Republic	Konsolidační banka (not a commercial bank)			State owned bank for bad debts during bank restructuring.		
Czech Republic	GE Capital (Agrobanka)	1998		Private domestic. Nationalized in 1996. Privatized in 1998	1998	2/9 (06/2001)
Czech Republic	Živnostenská Banka	2003		Domestic private.	2/2003	2.0 (06/2001)
Estonia	Optiva Pank	2000		Privatized 07/2000. Value: US$12.7 million.		
Hungary	General Banking Trust	1990			1996	3.5 (1999)

Country	*Bank*	*Year of Privatization*	*Method*	*Details*	*Strategic Owner*	*Market Share*
Hungary	Hungarian Foreign Trade Bank (MKB)	1994		Privatized.	7/1994	9.6 (1999)
Hungary	ABN Amro/Magyar Hitel Bank	1996		Privatized 12/1996. Merged with K&H 7/2001.	12/1996	5.8 (1999)
Hungary	National Savings and Commercial Bank (OTP)	1997	IPO	30 % sold through IPO October 1997. Further 41 % divested in October 1997, and 14.1 % by subsequent share offering in November 1999.		25.1
Hungary	Kereskedelmi and Hitel Bank (K&H)	1997		Minority share sold 7/1997. Merged with ABN Amro 7/2001.	7/2001	7.7 (1999)
Hungary	Postabank			Private domestic. Nationalized 1998.		4.7 (1999)
Hungary	Budapest Bank (BB)	1995		Privatized 12/1995.	12/1995	4.1 (1999)
Hungary	Central-European International Bank (CIB)	1998		Private domestic.	1998	8.0 (1999)
Kazakhstan	Industry and Construction Bank	1992		Privatized as Kredsoz Bank.		
Kazakhstan	Agroprom Bank	1993		Completely privatized by 1996.		
Kazakhstan	Turan-Alem Bank	1998				
Latvia	Unibank	1995	IPO	Government sold 66 % through IPO issued for privatization vouchers. Minimal government ownership after 1997 secondary offering of Global Depository Receipts.		
Latvia	Savings Bank	1997		Control transferred to private sector, government retaining 30 % share, reduced to less than 1 % by 2003.		
Lithuania	Savings Bank	2001	Tender	Government shares sold to Hansabank in September 2001		
Lithuania	Agricultural Bank	2002	Tender	Government sold 76 % to Nord LB (Germany)		

Country	*Bank*	*Year of Privatization*	*Method*	*Details*	*Strategic Owner*	*Market Share*
Macedonia, FYR	Stopanska Banka	1999		Majority share sold to Greek National Bank, itself also a state-owned bank 12/1999. Value: US$ 57.6 million.		
Poland	Bank Rozwoju Eksportu	1992	IPO	Government sold 47.5 % by IPO in July 1992 to hold 52.5 %.	10/2000	4.2 (1999)
Poland	Bank Slaski + ING-Barings (ING)	1993	IPO	Government sold 40.9 % by IPO in October 1993, 25.9 % by private placement in February 1994 to ING (Netherlands), to hold 33.2 %. Later merged with Warsaw branch of ING to form ING Bank Slaski – 88 % owned by ING.	7/1996	5.5
Poland	Wielkopolski Bank Kredytowy Spolka Akceyjna + Bank Zachodni (WBK + BZ)	1993	IPO	WBK privatized 3/1993. Government sold 55.72 % by IPO, 25.6 % by secondary offering in June 1994, 17.2 % by secondary offering in January 1996 to hold 5.1 %. BZ privatized 1999. Merger 12/2000.	WBK 4/1997 BZ 1999	5.4 (1999)
Poland	Bank Inicjatyw Gospodarczch + Bank Gdanski (BIG+BG)	1995	IPO	BIG domestic private. BG: Government sold 62.7 % by IPO in December 1995 to hold 37.3 %. BIG, a domestic bank acquired controlling interest and merged the bank to form BIG- Bank Gdanski 9/1998.	1/2001	6.3 (1999)
Poland	Bank Przemyslowo	1995	IPO	Government sold 50.1 % by IPO in January 1995 to hold 49.9 %. 37 % sold by tender to Bayerische Hypo-und Verinsbank in 1988, which acquired a controlling interest in 1999.		

Country	*Bank*	*Year of Privatization*	*Method*	*Details*	*Strategic Owner*	*Market Share*
Poland	Bank Handlowy + Citibank	1997	IPO	Government sold 95 % by IPO on June 30, 1997 to hold 5 %. Citibank acquired in 2000 88 % through the purchase of shares from original core investors (Yurich Insurance, Sparebanken Sverige and JP Morgan) as well as widely held sheres.	2/2000	8.0 (1999)
Poland	Bank Kredytowy	1997	IPO	Government sold 67 % to hold 33 %. Bank Austria acquired control in 2000, merging the bank with Bank Austria Creditanstalt Poland.		
Poland	Bank Zachodni	1999	Tender	Government negotiated sale of 80 % to Allied International Bank (Ireland). June 1999. Value: US$580million.		
Poland	Bank Gospodarki Zywnosciowej (BGZ)			State owned		5.1 (1999)
Poland	Bank Polska Kasa opieki S.A. Group (Bank Pekao SA)	1998	Tender-IPO	Privatized 6/1998. Government sold 52 % to foreign bank led consortium, 14 % to employees. Secondary offerings in 2000 divested government holding to less than 5 % with UniCredito Italiano holding a controlling stake (53 %). Value: US$ 1,090 million.	6/1999	17.5 (1999)
Poland	Powszechny Kaa Oszczednosci-Bank Panstwowy (PKO BP)			State owned.		17.6 (1999)
Poland	Kredyt Bank	1999		Private bank.	1999	4.3 (1999)
Poland	Bank Przemyslowo-Handlowy + Powszechny Bank Kredytowy (BPH + PBK)			BPH privatized 1/1995. PBK privatized 10/1997. Merger 12/2001.	BPH 11/1999. PBK 10/1997.	9.5 (1999)
Romania	Banca Romana Pentru Dezvoltare—Société Générale	1998	Tender	Government sold 41 % share		15.7 (03/2002)

Country	*Bank*	*Year of Privatization*	*Method*	*Details*	*Strategic Owner*	*Market Share*
Romania	Banc Post	1999	Tender	Government sold 42 % share, 4/1999.		4.1 (03/2002)
Romania	Raiffeseen—Banca Agricola	2001	Tender	Government sold 98 % to a consortium including Raiffeisen Zentralbank (Austria)	7/2001	3.5 (03/2002)
Romania	Romania Commercial Bank	2004		Agreement to sell 25 % to EBRD and IFC in 2003, interim step to full privatization.		
Slovakia	Slovenská Sporiteľňa	2000	Tender	Government sold 87 % to Erste Bank (Austria)		
Slovakia	Všeobecná a Úverová banka	2001	Tender	Government sold 94.5 % to Banca Intesa (Italy)		
Ukraine	Bank Ukraina	1993–1994		Shares distributed, mainly to employees, government continued to influence management.		
Ukraine	Prominvetbank	1993–1994		Shares distributed, mainly to employees, government continued to influence management.		
Ukraine	Ukrsotsbank	1993–1994		Shares distributed, mainly to employees, government continued to influence management.		

*The PeKaO Group in Poland includes three of the original nine commercial banks hived off from the portfolio of the central bank. These are Pomorski Bank Kredytowy (PBKS) in Szczecin, Bank Depozytowo-Kredytowy (BDK) in Lublin, and Powszechny Bank Gospardarczy (PBG) In Lodz.

Sources: Andrews (2005), Global Privatization Database, EBRD Transition Reports; Bonin, Hasan and Wachtel (2004); Annual Reports of central banks.

APPENDIX B

DE FACTO AND DE JURE CLASSIFICATIONS OF EXCHANGE RATE REGIMES

Reinhart and Rogoff (2002) de facto classification of exchange rate regimes:

1) no separate legal tender
2) pre-announced peg or currency board arrangement
3) pre-announced horizontal band, bandwidth not exceeding +/–2%
4) de facto peg
5) pre-announced drawling peg
6) pre-announced crawling band, bandwidth not exceeding +/–2%
7) de facto crawling peg
8) de facto crawling band, bandwidth not exceeding +/–2%
9) pre-announced crawling band, bandwidth exceeding +/–2%
10) de facto crawling band, bandwidth not exceeding +/–5%
11) moving band, bandwidth not exceeding +/–2%
12) managed floating
13) freely floating
14) freely falling
15) hyper floating

The IMF de jure classification (up to 1997)

(1) single currency peg
(2) SDR peg
(3) other composite currency peg
(4) flexibility vis-à-vis a single currency
(5) flexibility vis-à-vis group of currencies
(6) exchange rate adjusted according to indicators
(7) other managed floating
(8) independently floating

The IMF de jure classification (since 1998)

(1) no separate legal tender
(2) currency board arrangement
(3) other conventional fixed peg
(4) horizontal band
(5) crawling peg
(6) crawling band
(7) managed floating without pre-announced path for exchange rates
(8) independently floating

APPENDIX C

VARIABLE CONSTRUCTION AND DATA SOURCES

Dependent Variable: 1 if fixed exchange rate regime; 0 otherwise (flexible).

Variable	Preferred Regime (exp sign)	Scale	Definition and Data Sources
Financial Develop-ment	Fixed (+)	10-point scale	Financial Development index has 3 dimensions, and is the simple average of three variables: 1) the reform of banking institutions and regulations, adapted to a scale of 1–10, 2) the share of private banks in total bank assets, adapted to 0–10 scale, 3) the share of foreign banks in total bank assets. The index is not reported for Tajikistan, Turkmenistan, and Uzbekistan. The minimum value of the index is 0, meaning there is no change from the previous regime. The maximum value is 10, which corresponds to a full liberalization and institutional transformation of the financial sector. Source: Fries (2005), Anita Taci's data, EBRD Transition Reports, various issues. Alternative measures: 1) Credits issued by deposit money banks and other financial intermediaries to the private sector divided by GDP. Source: Thorsten Beck, Asli Demirgüç-Kunt and Ross Levine, (2000) updated through 2005. 2) The ratio of commercial bank domestic assets divided by commercial bank plus central bank domestic assets. Source: Thorsten Beck, Asli Demirgüç-Kunt and Ross Levine, (2000) updated through 2005. 3) Directed credit (a binary variable): countries in which credits to borrowers mandated by the government constitute more than 25% of the total credit volume in the economy are assigned a value of one; all others are coded zero. Source: Denizer, Desai, and Gueorguiev (2006).
Currency Mis-matches	Flexible (–)	Contin-uous	Ratio foreign liabilities to foreign assets held by banks as a proxy for the true currency mismatch since it only considers the liabilities held by banks with foreigners (i.e. non-residents) and the banks' claims on foreigners, irrespective of the currency of denomination. It excludes the foreign assets and liabilities held by banks with domestic residents. Source: Author's calculation using IMF International Financial Statistics (following Domac and Martinez Peria 2000). Alternative measure: Ratio of (gross) foreign liabilities to money stocks as a measure of dollarization. Source: Levy-Yeyati, Sturzenegger, and Reggio (2007).

(Continued)

Variable	Preferred Regime (exp sign)	Scale	Definition and Data Sources
Central Bank Independence	Fixed (+)	0–1 continuous	Central bank independence index/LVAW is weighted index of 16 characteristics of the Cukierman's measures of legal central bank independence that pertain to the allocation of authority over monetary policy, procedures for resolution of conflicts between the government and central bank, the degree of relative focus on price stability, limitations on lending, and the procedures for the appointment and dismissal of the governor of the central bank. 0=minimum minimum level of independence; 1=maximum level of independence. Source: Popova (2000) and Bodea and Popova (2005). Alternative measures: Cukierman, Miller and Neyapti (2002)
Economic Openness	Fixed (+)	ratio	Exports + Imports measured as a share of GDP. Source: IMF, International Financial Statistics.
Economic Size	Flexible (–)	continuous	Log of GDP in dollars over USA GDP. Source: World Development Indicators Series.
High Inflation	Flexible (–)	0–1 dichotomous	Dummy variable for high inflation: 1 if inflation > 150 %; 0 otherwise. Source: Author's calculations using World Bank Development Indicators; data from 1992 onwards are complemented by the 1999 EBRD Transition Report Update; the data for 1990 are from de Melo et al. (1996).
Capital Mobility	Flexible (–)	0–1 dichotomous	Dummy variable: 1 for the years when the country accepted the obligations under Article VIII of the IMF's Articles of Agreement; 0 otherwise. Source: Author's construction using the IMF Annual Reports on Exchange Arrangements and Exchange Restrictions, various issues.
Democracy	Flexible (+ given the scale of the index)	14-point scale	The ratings are based on a scale of 1 to 7, with 1 representing the highest and 7 the lowest level of democratic progress. I added the two scores for political rights and civil liberties to form a democracy index. Source: Author's construction using Freedom House, Annual Survey of Freedom Country at www.Freedomhouse.org.

(Continued)

Variable	Preferred Regime (exp sign)	Scale	Definition and Data Sources
Ratio of Industry & Agriculture to Services	Flexible (–)	ratio	Ratio of Industry +Agriculture to Services. Value of industry comprises the value added in mining, manufacturing, construction, electricity, water, and gas. Services include value added in wholesale and retail trade (including hotels and restaurants), transport, as well as government, financial, professional, and personal services such as education, health care, and real estate services. Source: Author's construction using World Development Indicators Series.
European Union	Fixed (+)	0–1 dichotomous	Dummy variable for the preparation to EU accession, taking a value of 1 from the year the country signed the EU Association Agreement or the Stabilization and Association Agreement (Croatia and Macedonia). Dates were given for when the agreements were signed. The agreements came into force at a later date. Source: Author's construction using the EBRD Transition Reports, various issues.
Distance from Brussels	Fixed (+)	continuous	A measure of geographical distance from Brussels (in km).
Party Ideology	Ambiguous	0–1 dichotomous	Dummy variable, taking a value of 1 if Left party, 0 if Right or Center party. Source: Author's construction using Philip Keefer, World Bank Database of Political Institutions, July 2005.
International Reserves	Fixed (+)	continuous	Gross reserves (end-year), excluding gold in months of imports of goods and services. Source: EBRD Transition Reports, various issues.
Latitude	Fixed (+)	continuous	The absolute value of the latitude of the country, scaled to take values between 0 and 1. Source: La Porta, Lopez-de-Silanes, Shleifer and Vishny (1999)
Executive Constraints	Flexible (–)	7-point scale	A seven category scale, from 1 to 7, with a higher score indicating more constraints. Score of 1 indicates unlimited authority: there are no regular limitations on the executive's actions, score of 3 indicates slight to moderate limitations, score of 5 indicates substantial limitations, score of 7 executive parity or subordination: Accountability groups have effective authority equal to or greater than the executive in most areas of activity. Source: Polity IV dataset, ICPSR.

APPENDIX D

SELECTED RECENT EMPIRICAL STUDIES ON EXCHANGE RATE REGIMES USING INTEREST GROUP VARIABLES

	Countries	Period	Dependent Variable	Measures of Interest Group Preferences	Control Variables
Frieden (2002)	EU members except Germany and Luxembourg plus Norway	1973–1994	Degree of fixity of the nominal exchange rate to the German mark: 1) annual rate of nominal depreciation; 2) annual coefficient of variation of monthly exchange rates	1)Interests of internationally engaged producers and investors: Level of manufactured exports to Germany; 2) import and export competition: changes in trade balance as a percent of GDP, controlling for the state of current account	Exports to the German currency blocks, import competition, central bank independence, Left parties, government instability, similarity of economic structures, growth, unemployment, the current account, the terms of trade, membership in the Snake/EMS, election timing, capital controls
Bearce (2003)	22 OECD countries	1975–1992	1) Monetary policy autonomy: interest rate differential; 2) monetary policy choice: central bank rate relative to the average of the Group 5 central banks rate	1) Relative strength of capital versus labor interests: capital/labor ratio; 2) export sector: export as a % of a country's total GDP; 3) financial services sector : banking as % of total GDP; 4) nontradable service sector: nontradable service sector net of financial services as % of GDP	Left government, party fractionalization, size, real growth of GDP, capital mobility, central bank independence, proportional representation, unionization rate, fixed regime in year

(Continued)

	Countries	Period	Dependent Variable	Measures of Interest Group Preferences	Control Variables
Shambaugh (2004)	Developing countries	1973–2000	Fix/float based on the IMF classification	1.Preferences of banks: a) private sector reliance on lending from commercial banks: private nonguaranteed bank debt burden; b) government reliance on lending from commercial banks: public guaranteed bank burden and other public guaranteed debt as a proportion of GDP; 2) export dependent sector; 3) import dependent sector; 4) specialized pass through	Change in the real exchange rate, level of democracy, elections, conservatism of the executive, controls on capital account, controls on current account, high inflation in past 5 years, foreign reserves, debt crisis, 1990s dummy
Blomberg, Frieden and Stein (2004)	26 Latin American and Caribbean countries	1960–1999	Duration and sustainability of a peg	Tradable sectors: manufacturing as a share of GDP	Real exchange rate, GDP growth, inflation, changes in government, elections, number of effective parties, the government vote share, political instability, central bank independence
Hall (2005)	27 developing countries (upper middle- and lower middle-income)	1987–1998	Duration and sustainability of a peg	1)Financial Intermediation: a) ratio of broad money to the monetary base; b) ratio of credit to the private sector to the monetary base; 2) liability dollarization: foreign liabilities/broad money supply multiplied by 100; 4) manufacturing: share of GDP produced by manufacturing	Capital mobility, inflation, current account/GDP, trade exposure, democracy, elections

APPENDIX E

DE JURE EXCHANGE RATE REGIMES IN EASTERN EUROPE, 1990–2004

COUNTRY	*EXCHANGE RATE REGIME*
Albania	Fixed peg: 1990–1991. August 1992: Managed float as part of the IMF stabilization program. Major reference currencies: EUR (DEM up to January 1, 1999) and USD. Monetary policy: informal inflation targeting through money growth targeting (since 1998).
Armenia	November 1993: exit from ruble zone. A national currency (dram) was introduced on November 22, 1993. December 1993: Independent float after a short period with a fixed peg to the USD.
Azerbaijan	Exit from ruble zone: July 1993. New currency (manat) was introduced on August 15,1992 and became the sole legal tender on January 1, 1994. March 1995: the exchange rate was effectively unified, when the government abolished the Unified Foreign Exchange Fund and allowed the rate applied for surrender requirements to align with the market rate. July 9, 1999: the manat devalued by 7% against US dollar, after having remained only CIS currency immune to the Russian crisis; managed float introduced.
Belarus	Exit from ruble zone: November 1993. A temporary currency (Belarusian ruble) introduced on May 25, 1992, and became the sole legal tender on 18 May 1994. A new national currency (ruble) introduced on August 20, 1994, and became the sole legal tender on October 21, 1994. Since 1996, the nominal exchange rate has been allowed to depreciate within a pre-established dollar band. The official rate has devalued by over 400% between September 1998 and June 1999. Crawling band was adopted.
Bulgaria	Free float/managed float from February 1991. Currency board from July 1, 1997. Exchange rate fixed at Lev 1,000 to DEM (EUR from 1999) (90 % devaluation over its previous rate). Monetary policy: nominal exchange anchor EUR (DEM) (since July 1997), money growth targeting.
Croatia	A new national currency (the Croatian dinar) introduced on December 23, 1991, and exchange rate peg to DEM. October 1993: devaluation of currency. May 30, 1994: Croatian dinar replaced by the kuna. Tightly managed float, reference currency, EUR (up to January 1, 1999 DEM). Since October 1993, the exchange rate fluctuated in a corridor of ±8 percent around the euro, and since 2002, a de facto corridor narrowed down to ±4 percent. Monetary policy: nominal exchange rate anchor EUR (DEM) (since October 1993).

(Continued)

COUNTRY	*EXCHANGE RATE REGIME*
Czech Republic	The initial choice of a "nominal anchor" foreign exchange rate regime was defined by the stabilization program jointly designed with the IMF in 1990, with the peg to USD/DEM combination being set after a cumulative devaluation of 95 %. January 1, 1991: currency basket peg regime, basket (45.52% DEM, 31.34% USD, 12.35% ATS, 4.24% GBP, 6.55% CHF. 2 January 1992: change in basket composition: 36.15% Dem, 49.07% USD, 8.07% ATS, 2.92% FRF, 3.79% CHF. February 1993: split of Czechoslovak currency—Czech koruna, no change in basket composition or band width. 3 May 1993: a peg to a basket (65% DEM, 35% USD) in ± 0.5 band from December 1990 until February 1996. The band was broadened to ± 7.5 % on 18 February 1996. The koruna was devalued on May 15, 1997. May 16, 1997: managed float with DEM and later EUR as reference currency was adopted (officially targeting domestic inflation rate). Monetary policy intermediate target evolved from the domestic credit volume target (1990) to a net domestic assets in the banking system target (1991/92) to a M2 (money and quasi money) "corridor."
Estonia	Exit from ruble zone: June 1992. A national currency (Kroon, EKK) introduced on June 20, 1992. Currency board regime, established in June 1992 EKK was pegged to the DEM at 8 EEK/1 DEM; from January 1999 to EUR at the market conversion rate: EEK 15.65/EUR. The main function of a currency board: the acquisition of hard currency in the interbank forex market. It also has some monetary policy tools: central bank bills issued since 1993 in very small amounts, low reserve requirements and standing deposit facilities. No lender or last resorts instruments available.
FYR Macedonia	April 26, 1992: A new currency (denar) was introduced, initially issued in the form of coupons, not backed by either gold or foreign exchange reserves. Notes and coins introduced April 1993. April 1992–September 1995: Flexible exchange rate with monetary targeting. Since October 1995: Peg to DEM (since January 1999 EUR). June 1997: devaluation by 16.2 %. Monetary policy: Nominal exchange rate anchor EUR.
Georgia	1991: Exchange rate unified. An interim and parallel currency, the Georgian coupon, was introduced in April 1993, and declared sole legal tender in August 1993. Due to very high inflation, domestic transactions were conducted in foreign currency or in the form of barter. October 1995: new currency (lari) introduced, and managed float adopted, later changed to conventional peg. December 1998: exchange rate regime modified from managed float to free float.

(Continued)

COUNTRY	*EXCHANGE RATE REGIME*
Hungary	Before 1989: Multiple exchange rates.March 21, 1989: peg against a basket according to currency composition of foreign trade. December 9, 1991: adjustable currency basket peg against a basket 50% ECU, 50% USD. Several moderate devaluations and several changes in basket composition as well as width of the fluctuation band between 1991 and 1995. July1, 1992: band with ±0.3%. August 2, 1993: pegging against a basket: USD 50%, DEM 50%. May 16, 1994: pegging against the basket USD 30%, ECU 70%. June 1, 1994: band with ± 0.5%. December 22, 1994: band width ±2.25%. March 16, 1995: crawling peg introduced, with monthly devaluations. January 1, 1997: basket of USDF 30%, DEM 70%. January 1, 1999: basket of USD 30% and EUR 70%. January 2000: crawling peg to EUR. May 4, 2001: simple peg with ±15% fluctuation band. June 4, 2003: one time 2.25% devaluation of central parity.
Kazakhstan	Exit from ruble zone in November 1993. Introduction of national currency (tenge) on November 15, 1993, and became the sole legal tender on November 18, 1993. As a part of April 1999 devaluation package, a 50% currency surrender requirement was introduced. Managed float adopted.
Kyrgyz Republic	Exit from the ruble zone in May 1993. Exchange rate unified and new currency (som) introduced on May 10, 1992, and became the sole legal tender on May 15, 1993. July 1998: abolition of all remaining foreign exchange controls. Managed float adopted.
Latvia	Exit from ruble zone in August 1992. A temporary currency—Latvia ruble or "rublis"–introduced May 7, 1992, and became the sole legal tender July 20, 1992. A new national currency (lat) introduced on June 25, 1993, and became the sole legal tender on August 1, 1993. A currency peg linked to the IMF's fiduciary account unit, the SDR with intervention bands (+/– 1%) introduced in October 1993.Currency board was established in 1994; with USD as the reserve currency.1997: SDR peg, fluctuation band +/–1%. 1999: SDR peg, fluctuation band: +/–1%.
Lithuania	Exit from ruble zone on October 1992. The ruble was initially replaced by an interim coupon currency from May to October 1992. A new temporary currency (talonas) introduced on May 1, 1992, and became the sole legal tender on October 1, 1992. The talonas, initially in a float regime, lost over 50% of its value between its introduction and April 1993. A new national currency (litas) introduced on June 25, 1993, and became the sole legal tender on August 1, 1993. The government with the support of the IMF decided to press for the constitution of an Estonian-type currency board arrangement already in October 1993 against the advice of the central bank. The currency board was finally introduced in April 1994 upon the unchanged administrative structure of the central bank. It is a modified currency board arrangement: reserve requirements and short term credit facilities, including for LLR operations preserved.

(Continued)

COUNTRY	*EXCHANGE RATE REGIME*
Moldova	September 1992: exchange rate unified. Exit from ruble zone: in November 1993. New currency (Moldovian coupons) established on July 24, 1993. Became sole legal tender on July 25, 1993. November 1993: a new currency, leu, introduced. Managed float changed to independent float in 1998.
Poland	Before 1990: multiple exchange rates, adjustable peg to a basket of currencies. January 1, 1990: after devaluation of zloty by 42%, exchange rate fixed to USD, 1 USD=9500 Zloty; linked to the need to fight hyperinflation as a part of an exchange rate based stabilization program. May 16, 1991: devaluation by 17% and exchange rate fixed to a currency basket (45% USD, 35% DEM, 10% GBP, 5% FRF, 5% CHF). October 14, 1991: crawling peg to the currency basket; with occasional step devaluation was introduced. January 1, 1995: redenomination—1 new zloty equal to 10,000 old zlotys. March 6, 1995: band widened ±2%. May 16, 1995: introduction of crawling band ±7%, crawling rate 1.2%. October 28, 1998: crawling band was widened to ±12.5%. January 1, 1999: change in currency basket: EUR 55%, USD 45%. March 25, 1999: monthly rate of crawl reduced to 0.3%, and band widened to ±15%. June 7, 1999: National Bank of Poland is not obliged to perform transactions with commercial banks during fixing. April 12, 2000: floating exchange rate and inflation targeting were adopted.
Romania	Managed float since 1991. Reference baskets: USD; since 2002: EUR(60%), USD (40%), since 2004: EUR(75%), USD(25%). Loosely managed float (August 2005). Monetary policy: money growth targeting, inflation targeting since August 2005.
Russia	From July 1992, the ruble's exchange rate came be announced as the single exchange rate reflecting market forces. Crawling band against the USD, replacing the previous "dirty float," was introduced in July 1995 designed to limit the ruble's fluctuation. In December 1995, the government adopted a target range of 4,500–5,150 rubles to USD. December 1996: the fluctuation range at 5,000–5,600 rubles to USD was adopted. In the beginning of 1998, a policy to fix the ruble's exchange rate at 6.2 rubles to 1 USD. In January 1998, a re-domination of the currency: 1,000 old rubles has effectively become new 1 ruble. In September 1998, the government shifted to a floating.

(Continued)

COUNTRY	*EXCHANGE RATE REGIME*
Slovenia	Tolar was introduced in 1991. Managed float (DEM and then EUR reference currency), closely managed on a gradually depreciating path. The Bank of Slovenia targets a domestic money aggregate (M3: money, quasi-money and time deposits) and informally shadowing the DEM.
Slovak Republic	Initial choice of "nominal anchor" foreign exchange rate regime was defined by the stabilization program jointly designed with the IMF in 1990, with the peg to USD/DEM combination set after cumulative devaluation of 95 %. January 1, 1991: currency basket peg regime, basket (45.52% DEM, 31.34% USD, 12.35% ATS, 4.24% GBP, 6.55% CHF). January 2, 1992: change in basket composition: 36.15% Dem, 49.07% USD, 8.07% ATS, 2.92% FRF, 3.79% CHF. February 8, 1993: Split of Czechoslovak currency—introduction of new currency—the Slovak koruna—basket: 36.16% DEM, 49.06% USD, 8.07% ATS, 2.92% FRF, 3.79% CHF, band ± 1.5%. July 10, 1993: devaluation 10%. July 14, 1994: basket changed: 60% DEM, 40% USD. January 1, 1996: band ±3%. July 31, 1996: band ±5%. January 1, 1997: band ±7%. Confronted with a fall in foreign exchange reserves and fears of currency devaluation, the National Bank of Slovakia replaced the currency basket peg with managed float on October 2, 1998. January 1, 1999: reference currency EUR.
Tajikistan	December 1991: central bank law adopted. Exit from ruble zone in May 1995. A national currency (Tajik ruble) introduced on May 10, 1995, and became the sole legal tender on May 15, 1995. May 1995: exchange rate unified. Independent float introduced.
Turkmenistan	Exit from ruble zone on November 1993. July 1993: foreign exchange reserves controlled by president. October 1993: central bank law adopted. A new currency—manat—introduced on 1 November 1993. April 1998: the commercial and official exchange rates were unified. Fixed peg adopted.
Ukraine	October 1991: central bank law adopted. Exit from ruble zone November 1992. The introduction of temporary currency—coupon-karbovanets—on November 12, 1992, and became the sole legal tender on November 16, 1992. The exchange rate of the coupon against the ruble not officially established, fluctuated de facto from 3 to 4 rubles per coupon. The exchange rate of the coupon against the USD was set at 10:1, whereas the black market rate was 100:1. August 1993: multiple exchange rates reintroduced: the National Bank of Ukraine official rate, the auction rate, the commercial rate of cash purchase-sale and the black market exchange rate. A new national currency—hryvnia—introduced on September 2, 1996. 1998: As part of the anti-crisis measures, the currency band was widened to 2.4 to 3.5 hryvnia to the USD in September 1998, leading to a depreciation of over 50% within a month. Managed float adopted.

(Continued)

COUNTRY	*EXCHANGE RATE REGIME*
Uzbekistan	Exit from ruble zone on November 1993. A temporary currency—sum-coupon—introduced on November 1, 1993. A new national currency—sum—introduced on November 15, 1993 and became the sole legal tender on 1 January 1994. The multiple exchange rates were institutionalized at the beginning of 1997 to support activities and investments in the government's priority sectors. The black market exchange rates were almost twice as high as the formal rates in mid-1998. 2000: two administrative exchange rates unified. June 2000: access to subsidized hard currency restricted. Managed float.

APPENDIX F

INFLATION PERFORMANCE IN EASTERN EUROPE, 1990–2004

The peak in inflation was in 1994, when average inflation rate was 1354 percent. In 2004, the average inflation rate was only 6.53 percent. As the table below shows, in terms of inflation performance, countries with pegged exchange rates—official and actual—experienced lower inflation that those with floats in different transition periods as well as the overall transformation period. The only exception seems to be the 1996–1999 period, during which countries pegged experienced higher inflation, compared to those that adopted floats. This finding seems to support the argument that credibility associated with fixed regimes helps governments achieve lower inflation. The data also suggest that official intermediate regimes have served as effective tools in inflation reduction: the average inflation rate in countries with soft pegs was 26 percent (in contrast with 341 percent in countries with floats).[651]

Inflation Performance (Mean) in EE

REGIME	*FIX*	*FLOAT*
De Facto		
1990–1995	45.04	853.40
1996–1999	31.85	89.45
2000–2004	6.70	15.02
Overall: 1990–2004	22.06	463.95
De Jure		
1990–1995	404.08	1062.97
1996–1999	61.84	58.85
2000–2004	6.91	11.10
Overall: 1990–2004	192.09	341.52

Differences in mean inflation rates are due to the missing data. The mean inflation for the missing observations for de facto classification represents in some periods twice as much as that for de jure classification.

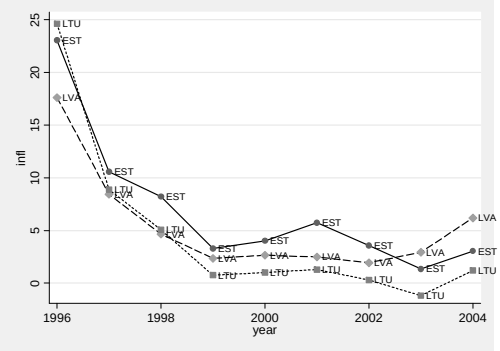
Source: Author's calculations based on the IMF Annual Report on Exchange Rate Arrangements and Restrictions, Reinhart and Rogoff (2004), Eichengreen and Razo-Garcia (1996), World Bank Development Indicators, and EBRD Transition Reports.

In spite of the variety of approaches to exchange rate policy, most EE countries have made substantial progress in reducing inflation by 2004. However, a gap opened in the inflation performance across transition economies: while many countries

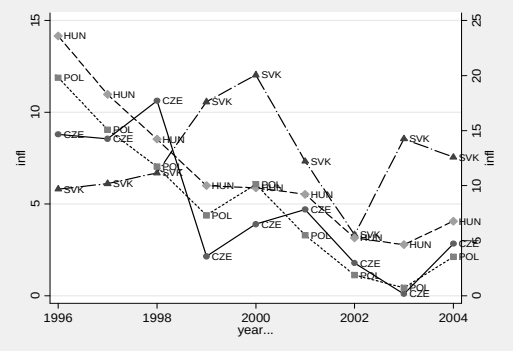
[651] The calculations are based on the de IMF classification of exchange rate regimes. The following regimes were coded as intermediate: horizontal band, crawling peg, and crawling band.

reached inflation rates below 10 percent, Belarus, Moldova, Russia, and Ukraine have all converged on inflation rates above 10 percent (see figure below). These are countries in which governments delayed financial reforms and closed financial markets to foreign competition, and so were not able to commit to sustainable fixed regimes.

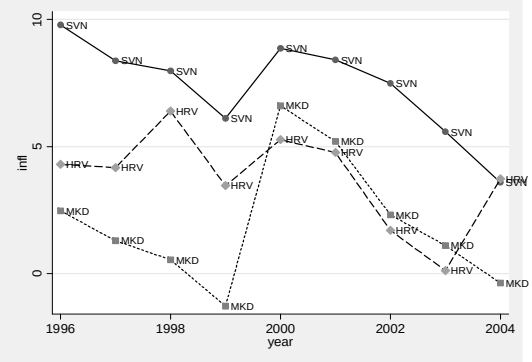
Estonia, Latvia, Lithuania



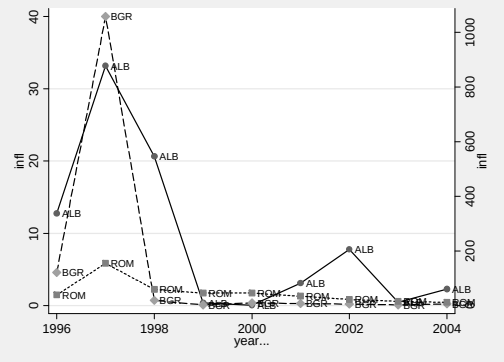
Czech Republic, Hungary, Poland, Slovakia



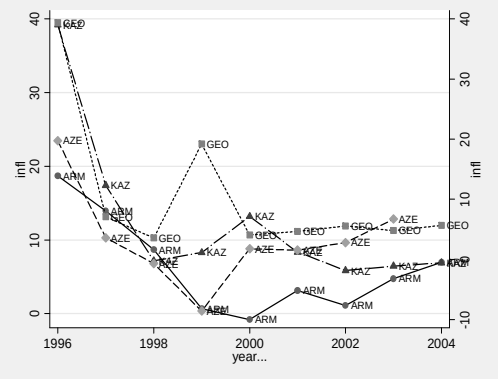
Croatia, Macedonia, Slovenia



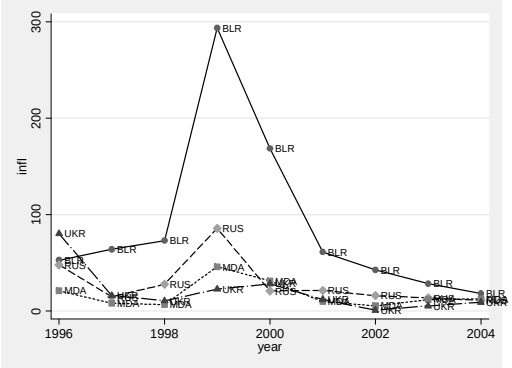
Albania, Bulgaria, Romania



Armenia, Azerbaijan, Georgia, Kazakhstan



Belarus, Moldova, Russia, Ukraine



Inflation Trends in EE, 1990–2004

APPENDIX G

LIST OF INTERVIEWS

ESTONIA

Ulo Kaasik, Head of the Economics Department of the BOE, July 18, 2008, Tallinn.

Mart Laar, former Prime Minister of Estonia (1992–1994 and 1999–2002), July 19, 2007, Tallinn.

Raul Malmstein, Chairman of the Management Board, Financial Supervision Authority, July 17, 2007, Tallinn.

Evald Mikkel, Department of Political Science, University of Tartu, July 20, 2007, Tallinn.

Karsten Staehr, Faculty of Economics and Business Administration, Tallin University of Technology, and Research Supervisor at the BOE, July 16, 2007, Tallinn.

BULGARIA

Roumen Avramov, former Member of the Managing Board of the BNB (1997–2002) and Economic Advisor to the President of the Republic of Bulgaria (1990–1991), June 24, 2007, Sofia.

George Chobanov, Vice-Dean and Professor of Economics, Faculty of Economics and Business, St. Kliment Ohridski University, June 27, 2007, Sofia.

Lubomir Christov, former Chief Economist and Member of the Managing Board of the BNB (1991–1994), June 29, 2007, Sofia.

Georgy Ganev, Program Director for Economic Research, Center for Liberal Studies, June 29, 2007, Sofia.

Emil Harsev, former Deputy Governor of the BNB, July 2, 2007, Sofia.

Kalin Hristov, Advisor to the Governor of the BNB, June 21 and 27, 2007, Sofia.

Petar Ignatiev, UBB Economist, formerly in the Banking Supervision Department of the BNB, June 25, 2007, Sofia.

Tsvetan Manchev, Deputy Governor of the BNB, June 26 and July 2, 2007, Sofia.

Ivan Mihalev, Financial Journalist, Capital Weekly, June 25, 2007, Sofia.

Veselin Mintchev, Bulgarian Academy of Sciences, Institute of Economics, June 27, 2007, Sofia.

Nikolay Nenovsky, Member of the Governing Council of the BNB, June 26, 2007, Sofia.

Boris Petrov, Head of Analysis Division Treasury of the BNB, June 28, 2007, Sofia.

Lena Roussenova, former Member of the Governing Council of the BNB, June 22, 2007, Sofia.

Martin Zaimov, former Deputy Governor of the BNB and Chairman of the Currency Board (1997–2000), June 28, 2007, Sofia.

CZECH REPUBLIC

Vít Bárta, Advisor to the Vice-Governor of the CNB, June 9 and June 13, 2006.

Oldřich Dědek, Professor of Economics at Charles University, former Advisor to the Governor of the CNB and to the Prime Minister of the Czech Republic, Vice-Governor of the CNB (1999–2005), June 12 and 10, 2006, Prague.

Milena Horčicová, Director of the Department for Financial Policies, Ministry of Finance, June 15, 2006, Prague.

Miroslav Hrnčíř, Advisor to the Governor of the CNB, former member of the CNB Board, June 7, 2006, Prague.

Tomáš Ježek, former Minister of Privatization (1990–1992) and President of the National Property Fund (1992–1994), June 20, 2006, Prague.

Ivan Kočárník, former Minister of Finance (1992–1997), June 14, 2006, Prague.

Karel Kříž, former Advisor to the Chairman of the Executive Committee of the National Property Fund, June 5, 2006, Prague.

Willy Kiekens, IMF Executive Director, June 6, 2006, Prague.

Pavel Mertlík, former Minister of Finance (1999–2001), Chief Economist in Raiffeisenbank, June 16, 2006, Prague.

Petr Dufek, Director of Macroeconomic Research, Czechoslovak Commercial Bank, June 16, 2006, Prague.

Jan Mládek, former Minister of Agriculture (2005–2006), First Deputy Minister of Finance (1999-2001), and Deputy Minister of the Federal Ministry of Economy (1991–1992), June 9, 2006, Prague.

Pavel Štěpánek, Deputy Director of the Czech Banking Association, June 20, 2006, Prague.

Zdeněk Tůma, Governor of the CNB, June 15, 2006, Prague.

POLAND

Marek Dabrowski, former First Deputy Minister of Finance (1989–1990), Member of Parliament (1991–1993), and Member of the Monetary Policy Council of the NBP (1998–2004), July 3, 2006, Warsaw.

Andrzej Bratkowski, former Advisor to Balcerowicz, Deputy President of the NBP, and Chief Economist of Bank Pekao SA, July 17, 2006, Warsaw.

Michal Federowicz, Institute of Philosophy and Sociology, Polish Academy of Sciences, July 4, 2006, Warsaw.

Dariusz Filar, Member of the Monetary Policy Council of the NBP, July 11, 2006, Warsaw.

Stanislaw Gomulka, former Advisor to Balcerowicz and Reader in Economics at the London School of Economics, 13 July 2006, Warsaw.

Boguslaw Grabowski, Member of the Monetary Policy Council of the NBP (1998–2004), July 17, 2006, Warsaw.

Wlodzimierz Grudzinski, President of the Bank for Socio-Economic Initiatives and Member of Management Board of the Association of Polish Banks, July 16, 2006, Warsaw.

Jerzy Hausner, former Minister of Labor (2001–2003), Minister of State Treasury (2004) and Minister of Economy (2003–2005), July 6, 2006, Warsaw.

Stefan Kawalec, former General Director in the Ministry of Finance and Chief Advisor to Deputy Prime Minister Balcerowicz (1989–1991), Deputy Minister of Finance (1991–1994), July 16, 2006, Warsaw.

Grzegorz Kolodko, former Minister of Finance (1994–1997 and 2002–2003), July 2 and 5, 2006, Warsaw.

Piotr Kozarzewski, Senior Expert, Center for Social and Economic Research, July 5, 2006, Warsaw.

Waldemar Kuczynski, former Chief Economic Advisor of Mazowiecki, Minister of Privatization and Chief Economic Advisor of Jerzy Buzek (1997–2001), July 17, 2006, Warsaw.

Andrzej Topinski, former Vice-Governor of the NBP (1989–1992), President of the Polish Bank Association, July 14, 2006, Warsaw.

Zbigniew Polanski, Advisor to President of the NBP Leszek Balcerowicz and Professor of Economics, Warsaw School of Economics, July 11, 2006, Warsaw.

Jerzy Pruski, First Deputy Governor of the NBP, July 12, 2006, Warsaw.

Krzysztof Rybinski, Deputy President of the NBP, July 5, 2006, Warsaw.

Piotr Spzunar, Deputy Director, Macroeconomic and Structural Analyses Department of the NBP, July 3, 2006, Warsaw.

Katarzyna Zajdel-Kurowska, Chief Economist and Head of Treasury Research, Citibank Handlowy, July 14, 2006, Warsaw.

SLOVAKIA

Elena Kohútiková, Vicegovernor of the NBS (2000–2006), December 6, 2005, Bratislava.

Karol Mrva, Member of the NBS Board, Executive Director Financial Market Operations, December 9, 2005, Bratislava.

Ján Oravec, President of the National Union of Employers (representing enterprises with foreign capital in Slovakia), December 15, 2005, Bratislava.

Juraj Paľa, Director of the Department of the European Union, Slovak Chamber of Commerce and Industry, December 13, 2005, Bratislava.

Juraj Renčko, former Advisor to the Minister of Finance of the Slovak Republic, and the Head of the Coordination Unit for Bank and Enterprise Restructuring and Privatization (1999–2002), December 2005, Bratislava.

Peter Ševčovic, Member of the Bank Board of the NBS, Bratislava, December 2005.

Ladislav Vaškovič, CEO of EXIMBANKA, former Chairman of the Board of VUB, December 12, 2005, Bratislava.

Ján Vlčko, Associate Director of the Department of the European Union, Slovak Chamber of Commerce and Industry, December 13, 2005, Bratislava.

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